

# IMF Macroeconomic Stabilisation and Adjustment Programmes: Rhetoric, Scholarship, and Policy

By

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# Abstract

This thesis is about the macroeconomics of IMF stabilisation and adjustment programs which, according to official statements, are designed to “get macroeconomic fundamentals right and dismantle government-imposed distortions or put in place various institutional features of a modern market economy”. From the resulting macroeconomic stability and market liberalisation, high rates of growth and reduction in poverty are to be achieved. However, experience has shown without a doubt the inadequacy of IMF programs to achieve these objectives. This thesis argues the failure lies in the IMF’s underlying view of state-society relations.

The IMF introduced the original financial programming (FP) model, but has since picked up neoclassical supply-side theory to address long-term structural issues. However, both in absolute terms and relative to concomitant best practice, the macroeconomic theory and rationale underlying IMF programmes have been inadequate, especially in the context of developmental needs beyond low inflation and positive growth rates. IMF programmes have failed to link the short run measures with long run objectives, and are totally inappropriate for addressing issues of structural transformation as the Ethiopian and Ugandan case studies demonstrate. Despite justifiable criticisms as well as inconclusive empirical work on the impact of its programmes, the IMF’s response is increasingly to search for developments in neo-liberal political theory to vindicate its standpoint. Interest-group pressure and lack of political commitment are seen as causes of failure and policy non-adoption, which have left the major weaknesses of the programmes unexposed. Zealous approach to financial austerity and neglect of systematic intervention and the specificities attached to individual countries have set aside the developmental role of the state, despite conclusive evidence that it has contributed to industrialisation in other parts of the world, not least East Asia. Under the guise of being faithful to the market, IMF programmes are smokescreens behind which highly interventionist policies alter state-society relations, yielding a set of confusing paradigms in the study of development.

# Table of Contents

<b>Chapter 1: Introduction and Overview</b>	<b>9</b>
1.1 Whence and whither IMF Lending?	9
1.2 Conditional Lending	11
1.3 The Politics of IMF Lending	17
1.4 Organisation of the Thesis	20
1.5 IMF Stabilisation Programmes	22
1.6 IMF Adjustment Programmes	24
1.7 The Impact Analysis	29
1.8 IMF Programmes in Ethiopia and Uganda	32
1.9 The Developmental State is the Missing Link	34
1.10 Appendix 1: IMF Facilities	38
Notes	39
<b>Chapter 2 IMF Stabilisation Programmes: Demand-Side Policies</b>	<b>44</b>
2.1 Introduction	44
2.2 Why Stabilisation and Adjustment	47
2.3 The General Macroeconomic Framework	49
2.3.1 The Private Sector	49
2.3.2 The Government Sector	50
2.3.3 The Foreign Sector	51
2.3.4 The Monetary Sector	52
2.3.5 National Income and Absorption	52
2.3.6 Savings and Investment	54
2.3.7 Public Sector Deficit	56
2.3.8 Balance of Payments Deficit	57
2.4 The Monetary Approach to the Balance of Payments	57
2.4.1 The Polak Model	58
2.4.2 The Polak Model and Real Variables	64
2.4.3 The Chicago Model	67
2.5 A Complete Model for IMF Financial Programming	70
2.6 Critique of IMF Stabilisation Programmes	74
2.7 Concluding Remarks	83
Notes	86
<b>Chapter 3 IMF Adjustment Programmes: Supply-Side Issues</b>	<b>89</b>
3.1 Introduction	89



3.2	The Search for a "Growth-Oriented" Model	95
3.2.1	The World Bank model	97
3.2.2	The Merged Model of FP and RMSM	102
3.3	Financial Liberalisation	109
3.3.1	Financial Liberalisation Contested	116
3.4	Trade Liberalisation	123
3.4.1	Trade Liberalisation Contested	128
3.5	Exchange Rate Policy and Expenditure-Switching	132
3.5.1	Expenditure-Switching Contested	136
3.6	Privatisation	142
3.7	Concluding Remarks	148
	Notes	151
<b>Chapter 4</b>	<b>The Impact of IMF Programmes: The Empirical Evidence</b>	<b>153</b>
4.1	Introduction	153
4.2	Why We Don't Know Whether IMF Programmes Work or Not	160
4.3	The Before-After Approach	161
4.3.1	Empirical Evidence from Before-After Studies	161
4.4	The With-Without Approach	166
4.4.1	Empirical Evidence from With-Without Studies	167
4.5	The Modified With-Without Approach	170
4.5.1	Empirical Evidence from the Modified Studies	171
4.6	The Multiple-Regression and Structural Approaches	174
4.6.1	Empirical Evidence from Multiple-Regression Studies	176
4.7	The Actual versus Target Approach	179
4.7.1	Empirical Evidence from Actual versus Target Studies	179
4.8	Are IMF Programmes Implemented As Agreed?	182
4.9	Who Adopts IMF Programmes and Why?	185
4.10	Concluding Remarks	188
	Notes	192
<b>Chapter 5</b>	<b>IMF Programmes in Ethiopia and Uganda</b>	<b>196</b>
5.1	Introduction	196
5.2	Methodological and Data-Related Issues	202
5.3	Statistical Tests and Results	206
5.3.1	Test Results for Real Per Capita GDP and Real Growth of GDP	207
5.3.2	Test Results for Inflation Rates	208
5.3.3	Test Results for Current Account Balance and International Reserves	210
5.3.4	Test Results for Policy Variables	214
5.3.5	Discussion on Policy Variables	216
5.3.6	Performance and Programme Completion	220

5.4	Absence of Structural Transformation	222
5.6	Concluding Remarks	227
	Appendix 5.1	230
	Notes	242
<b>Chapter 6</b>	<b>From Stabilisation to Adjustment: Is the Developmental State the Missing Link?</b>	<b>246</b>
6.1	Introduction	246
6.2	The Developmental State	252
6.3	The Developmental State Contested	257
6.4	Can the African State be Developmental?	272
6.4.1	Is a State with a Developmental Vision Absent in SSA?	274
6.4.2	Do Powerful Interests Get in the Way of the Developmental State?	279
6.5	Programme Failure: Vindication and Entry-Strategy	287
6.5.1	Conditionalities Erode Ownership	296
6.5.2	Conditionalities Nurture Repression	305
6.6	Beyond the <i>Repressive Pseudo-Developmental State</i>	307
6.7	Concluding Remarks	318
	Notes	323
<b>Chapter 7</b>	<b>Conclusion</b>	<b>331</b>
7.1	Rhetoric, Scholarship and Policy	331
7.2	The Conceptual Framework	333
7.3	The Empirical Evidence	335
7.4	IMF Programmes in Ethiopia and Uganda	336
7.5	The Developmental State is Missing Link	337
7.6	Direction for Future Research	338
<b>References</b>		<b>340</b>

## List of Tables and Figures

Tables		Pages
Table 1.1	IMF Programme and Financial Arrangements	13
Table 1.2	IMF Voting Power on April 30, 2002	17
Table 4.1	Summary of Research on the Impact of IMF Programmes	181
Table 5.1	Trends in Inflation Rates, 1990/91 – 1996/97	210
Table 5.2	Structure of Import Duties, 1993-2000 (number and per cent)	213
Table 5.3	Ethiopia: Percentage Share in Total Value of Imports, 1992-1998	213
Table 5.4	Sectoral Percentage Share of Total Export Earning, 1990-1998	218
Table 5.5	Real Interest on Time Deposit, 1985-2001	220
Table 5.6	Share of Credit by Sector in Total Bank Credit, 1992-2002	226
Table 5.7	IMF Lending Arrangements to Ethiopia and Uganda, 1981-2005	230
Table 5.8	Ethiopia: Short-term Before-After Comparisons for Target Variables under Mann-Whitney U-test	231
Table 5.9	Uganda: Short-term Before-After Comparisons for Target Variables under Mann-Whitney U-test	233
Table 5.10	Ethiopia: Statistical Results for Long-Term Comparisons under Before-After Comparisons	235
Table 5.11	Uganda: Statistical Results for Long-Term Comparisons under Before-After Comparisons	236
Table 5.12	Ethiopia: Statistical Results under Before-After for Individual Programme Comparisons	237
Table 5.13	Uganda: Statistical Results under Before-After for Individual Programme Comparisons	238
Table 5.14	Statistical Results for With-Without Comparisons: Botswana v Ethiopia/Uganda	239
Table 5.15	Statistical Results for With-Without Comparisons: Botswana/Namibia/Seychelles/Sudan v Ethiopia/Uganda	240
Table 5.16	Statistical Results for Long-Term Test under Before-After Comparisons for Structural Transformation	241
 <b>Figures</b>		
Figure 3.1	Model of the McKinnon-Shaw Hypothesis	113
Figure 5.1	Manufacturing Output as a Share of GDP (Percentage, 1965-2001)	225

# Chapter 1

## Introduction and Overview

The political and economic changes in developing countries not least sub-Saharan Africa (SSA) in the last two decades have inspired a concomitant shift in understanding of the intellectual foundations of their economic malaise and its treatment. This led to a plethora of studies on the relationship between SSA and the international system including the impact of the financial institutions, particularly the International Monetary Fund (IMF). The role of the IMF in stabilisation and structural adjustment has been the subject of a number of books, articles, conferences and commentary. This thesis is a contribution to this literature. The originality is in the context of bringing together the three strands of IMF programmes, specifically the theoretical underpinnings, the impact analysis and the political economy of reform, and in showing, with reference to Ethiopia and Uganda, that the rationale underpinning IMF programmes has set aside the developmental role of the state. This is despite conclusive evidence that state intervention has contributed to industrialisation in other parts of the world. Indeed there is a theoretical, historical and empirical case for state intervention to guide structural transformation. The East Asian developmental states were successful in achieving rapid growth not least in the state mobilising finance and because of state-society relations that allowed for selective credit, subsidies, protection, and other industrial policies.

### 1.1 Whence and whither IMF Lending?

The post-WWII global economy faced declining commodity prices and decreases in international trade, which resulted from many countries opting for competitive exchange rate adjustments and direct control of imports. This was mainly the result of the Great Depression and the effect of the war itself. There was a need for official capital flows as the depression also disrupted private capital markets. An international institution

was required to coordinate official financing and monitor exchange rate movements, hence establishment of the IMF (Krueger, 1998b). The Conference at Bretton Woods was based on the proposals written by John Maynard Keynes representing Europe and Alvin Hanson, Jacob Viner, and Harry Dexter White from the United States.<sup>1</sup> It is clear that the U.S. had leverage over the negotiations, as much of Europe relied on U.S. assistance both militarily and in financial aid.<sup>2</sup> As stated by Singer (1995, p. 12):

“The guiding principle of the original vision was “Never Again!” Never again to permit the conditions of the 1920s and 1930s with their mass unemployment, protectionist beggar-thy-neighbour policies, competitive currency devaluations, deflation, collapse of commodity prices, stock exchange crashes, etc.”

The purposes of the IMF as specified under its Article of Agreement, Article 1 are:

1. To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems;
2. To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy;
3. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation;
4. To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions, which hamper the growth of world trade;
5. To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity; and
6. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

As the IMF was a guardian of the Bretton Woods system, its role was questioned following its breakdown.<sup>3</sup> The two successive oil price rises in the 1970s paved the way for the IMF to extend lending to developing countries and find a new forte. The IMF overlooked the oil price increases in 1973 and 1979 and applauded the transfer of surplus from oil-exporting countries to deficit countries as indication of a sound financial system.

The industrial economies responded by restrictive demand for the purpose of reducing inflation. Although commercial banks were able to recycle the surplus from oil exporting economies, the consequent debt crisis of the early 1980s in Latin America further increased the demand for multilateral finance. As the resources of the IMF are not designated to reduce the volume of the debt, the option became planning change in domestic policy making through what became to be known as stabilisation policy, which mainly consisted of short-term assistance to correct disequilibrium in the balance of payments (Kruger, 2000).

Given the economic difficulties faced by most developing countries in the last twenty years, there was a need for adjustment with external financial assistance. It is precisely the shortage of non-conditional and concessional finance from bilateral and private sources that elevated the IMF, and the World Bank, from multilateral sources of finance to dominant institutions in development policy making.<sup>4</sup> The IMF acquired a mandate to prescribe development policies when an unprecedented global problem paved the way for the emergence of the neo-liberal ideology – the oil crisis in the early 1970s.

At the time of the Bretton Woods conference the negotiators were concerned with the economic decline described above and not with the question of development. Latin American and Asian countries were net creditors and Africa was entirely under colonial rule. It is the deterioration in commodity prices, the debt burden in Latin American countries and later the emergence of new African states that brought the IMF's focus into development. The subsequent involvement of the IMF in troubled Latin American and SSA countries is, therefore, a departure from its initial short-term stabilisation into long-term commitment through conditional finance.

## **1.2 Conditional Lending**

IMF balance of payments financing is arranged under Stand-by and Enhanced Fund Facility (EFF). Since the mid-1980s medium-term Structural Adjustment Facility

(SAF) and Enhanced Structural Adjustment Facility (ESAF renamed in 1999 as Poverty Reduction and Growth Facility, PRGF) were created specifically for low-income countries (see Appendix 1). The IMF's task over the years has changed from those set out in the Articles of Agreement to the new role in direct intervention in most economies via conditional finance. The *conditional* refers to policies a borrowing country must adopt, often a complete reversal of policies adopted during the *status quo ante*. The extension of IMF programmes from its traditional focus on stabilisation into more elaborate and comprehensive structural reforms has meant long-term financial commitment as well as extensive conditionalities (Polak, 1991).<sup>5</sup> These policies, as a matter of formal procedure, are listed in a *letters of intent and memorandum of understandings*, which are prepared by the recipient country and the IMF.

According to its recent report (IMF, 2002a, p. 1), the IMF stated: "When a country borrows from the IMF, its government makes commitments on economic and financial policies—a requirement known as conditionality." The purpose of conditionality, according to the IMF, is to provide assurance that its finances will be used to improve the economy of the recipient country (resolve balance of payments difficulties and promote economic growth) and that the country will be able to make repayments, so that the IMF lends the money to other clients (IMF, 2002c). As members' quotas in the IMF did not grow in line with the growth of world trade, it was necessary to attach conditionality on borrowing above quota (IMF, 2001a, 2001b and Khan and Sharma, 2001).<sup>6</sup> The IMF (2001a) insists that its tranche of financing and conditionality are intended to prevent the motivation of governments from pursuing inflationary policies. This is related to the moral hazard argument that governments will pursue bad policies if they feel they will be rescued by the IMF (Guitián, 1992 and IMF, 2001a). Conditionalities are also used for monitoring of programmes; as a signal for indicating when programmes go off-track; as an assurance for access to IMF finances; as a sign of commitment to policy change; and they provide credibility to reforms (Rodrik, 1989 and Casella and Eichengreen, 1996). Conditionalities are guarantee in the absence of some sort of collateral, which commercial banks would have used (Sachs, 1989a and Mosley, 1992a and 1992b). Most

important, conditional lending is designed to induce change of development strategy: a mechanism for behavioural alteration (Collier and Gunning, 1996).<sup>7</sup>

Compliance to IMF conditionality is assessed in various ways. Loans from the IMF are released in “phased disbursements” or tranching, which gives it leverage over the recipient country. Disbursement of funds is in response to performance monitoring through (see IMF, 2001b):

- ❑ **Prior Actions (PAs):** These are actions that a country agrees to take as precondition before the IMF loan is approved such as adjustment of the exchange rate.
- ❑ **Performance Criteria (PCs):** These are conditions, which must be carried through at a specific time by a country to be allowed to draw credit from the IMF. These may include quantitative floors/ceilings or structural indicators. There are two types of PCs:
  - **Quantitative PCs:** these refer to macroeconomic policy variables such as international reserves, monetary and credit aggregates, fiscal balances, or external borrowing.
  - **Structural PCs:** Measures to restructure key sectors such as public sector reform and privatisation.
- ❑ **Structural Benchmarks (SBs):** Similar to structural PCs and mainly attached to SAF and ESAF programmes, SBs focus on concrete structural indicators such as institutions changes (for example introducing export promotion agencies and a new banking or investment law) and broadening of the tax base.
- ❑ **Programme Reviews (PRs):** These are periodic reviews to assess progress of implementation of programmes and introduce changes that may be necessary in light of new developments.

The conceptual foundation underlying conditionalities can be seen as a principal-agent problem, in which asymmetry in the availability of information determines the relationship between the principal and the agent. In financial transactions, this popular theory asserts a borrower (agent or entrepreneur) has better information about capacity and opportunity than the lender (principal or financial institution). Such divergence in information leads to two negative externalities: adverse selection and moral hazard. Adverse selection blurs the distinction between a viable borrower and a potential defaulter, while moral hazard provides the wrong incentive for the borrower to engage in



more risky activities.<sup>8</sup> In this case, concessionary IMF lending may be an incentive for borrowers to deliberately search out for balance of payments crisis to acquire funding.<sup>9</sup> For the IMF (2001a), its tranche of financing and conditionality are solutions for avoiding adverse selection and moral hazard in the form of continuous monitoring and control. The justification is further extended, as the agent in this case is a government, which cannot be sued for default because programme outcomes are determined not only by the actions of central bankers and finance ministers, but also other stakeholders such as professional associations. According to Khan and Sharma (2001, p. 6):

“Like any lender, the IMF thus needs assurances from its borrowers that the funds lent to them would be used for the purposes defined by the Articles of Agreement, and in a manner that does not jeopardise their contractual servicing and repayment. Consequently, many of the finance propositions relevant to private financial institutions apply equally to the IMF.”

The analysis of conditionality as an agency problem explains the conflict between the IMF and the recipient country, which arises in the process of stabilisation and adjustment. It also allows examining the limitations of the incentive structure as well as the penalty for non-compliance. What this reveals is the divergence in objectives between the IMF and the recipient country. Conditionality appears as a type of agency problem as the IMF is the “principal seeking to induce foreign governments (the agents) to undertake certain actions in return for access to international capital” (Killick, 1996, p. 27).

The number of conditionalities has been steadily growing since 1990. According to the IMF, “in 1987, Fund-supported programmes contained on average two structural conditions per programme year; by 1994, this number had increased to 7, rising further to an average of 14 structural conditions per programme year in 1999” (IMF, 2001b, p. 9). SAF and ESAF/PGRF programmes carry more conditionalities than the traditional one-year Stand-by programmes.<sup>10</sup> Between 1987-1999 the highest conditionality was observed in the fiscal sector followed, in order of high to low conditionality, by the financial sector, privatisation, tradable sector, public enterprise reform, exchange system and pricing and marketing. Structural conditionalities are also the highest in transition economies and non-transition ESAF/PGRF countries, which are mostly the least-

developed countries in the SSA region (IMF, 2001b).<sup>11</sup> As Table 1.1 shows the IMF has been increasing its conditional lending since 1987 and the total number of programmes more than doubled from 32 in 1987 to 96 in 2002. In the same period the amount of SDR committed also went up from SDR4,476 to SDR87,242. The IMF increasing involvement in structural issues is illustrated from the increasing number of PGRF programmes, which went up from 7 in 1989 to 35 in 2002. PGRF programmes make up 51 per cent of total IMF programmes and 80 per cent of these are implemented in SSA. Although these programmes make up only 9 per cent of the total SDR disbursed under all IMF programmes, the increase in monies committed - between 1989 and 2002 - is 77 per cent.

**Table 1.1 - IMF Programmes and Financial Arrangements**

Number of Arrangements as of April 30						Amounts Committed Under Arrangement as of April 30 (In millions of SDRs)				
Year	S-By	EFF	SAF	PGRF	Total	S-By	EFF	SAF	PGRF	Total
1987	22		10	-	32	4,118		358	-	4,476
1988	14	1	15	-	30	1,702	245	670	-	2,617
1989	12	1	4	7	24	2,956	207	427	955	4,545
1990	16	3	3	11	33	3,249	7,627	37	415	11,328
1991	14	5	12	14	45	2,703	9,597	539	1,813	14,652
1992	22	7	8	16	53	4,833	12,159	101	2,111	19,203
1993	15	6	4	20	45	4,490	8,569	83	2,137	15,279
1994	16	6	3	22	47	1,131	4,504	80	2,713	8,428
1995	19	9	1	27	56	13,190	6,840	49	3,306	23,385
1996	21	7	1	28	57	14,963	9,390	182	3,383	27,918
1997	14	11	-	35	60	3,764	10,184	-	4,048	17,996
1998	14	13	-	33	60	28,323	12,336	-	4,410	45,069
1999	9	12	-	35	56	32,747	11,401	-	4,186	48,334
2000	16	11	-	31	58	45,606	9,798	-	3,516	58,921
2001	25	12	-	43	80	61,305	9,798	-	4,576	75,670
2002	26	8	-	35	69	74,344	8,697	-	4,201	87,242

*Source: IMF (2002c)*

In the 1980s the IMF moved into structural or adjustment programmes and away from its traditional macroeconomic stabilisation policies and in effect, became party to

and repayment guardian for commercial lenders and got involved in frequent negotiations and rescheduling of external debts – the role of “gatekeeper”. It advises countries in formulating debt repayment schedules with official creditors in the Paris Club and with private lenders in the London Club. The IMF has become so influential that any other bilateral, multilateral, and commercial bank lending and development assistance depends on its prior approval of “creditworthiness” of a country – the so-called “catalyst function”. Countries, which for political, ideological reasons or dislike of strict conditionalities did not use IMF facilities, have suffered severe shortages of finance not only from resources foregone from the IMF but those that follow its approval.

Throughout the 1990s the IMF indulged in issues of poverty, governance, gender, and the environment. In his speech, the former Managing Director, said: the IMF strives to promote growth, which is based on “equity, poverty alleviation, and empowerment of poor people; and growth that promotes protection of the environment, and respect for national cultural values” (quoted in Goldstein, 2000, p. 2). Now the IMF is not only a monetary institution but also a “quasi-developmental” body.<sup>12</sup> One example is the Highly-Indebted Poor Countries (HIPC) initiative, which the IMF has designed, in conjunction with the World Bank, to reduce multilateral debt. IMF and World Bank credits are not eligible for forgiveness as well as rescheduling of arrears. This was much to do with keeping their credit rating. The multilateral debt burden is serious and the countries ability to pay remains doubtful. What gave rise to the HIPC is precisely the unsustainability of multilateral debt.

At the same time, following the balance of payments as well as financial crises in Mexico, South Korea, Thailand, Indonesia, and Malaysia, the IMF’s role as crisis manger and crisis averter became paramount. The Asian financial crisis also brought the IMF’s function of surveillance into public debate.<sup>13</sup> This function was significantly reviewed in the second amendment of the Articles of Agreement in 1977 to take account of developments in international financial flows. The IMF’s new role as crisis averter raises questions: whether it has enough resources to bail out crisis-hit countries and its failure to predict the 1997 crisis in East Asia, in 1994 in Mexico or for that matter the 2001 crisis in

Argentina. The reservation on the crisis averting and crisis managing role of the IMF focuses on the fact that the IMF's traditional approach is not suited to the new problems taking place in the world, particularly the transition from central planning as well as financial crisis. The question is whether the IMF is institutionally and intellectually catching up with the changing conditions of the world economy (Singer, 1995).<sup>14</sup>

### 1.3 The Politics of IMF Lending

The IMF has a tradition of making closed deals, failing to practice dialogue with key members of society who are affected by its programmes.<sup>15</sup> A recent study found that the issue of transparency was also a concern among even those who supported IMF sponsored programmes used the words "secretive" and "arrogant" (Locke, 2000, p. 5).<sup>16</sup> Accountability of the IMF is questioned as Central bank governors and finance ministers, who are not typically elected representatives, have powerful control over it. Stiglitz (2000b, p. 5) further states;

"Indeed, it is ironic that in an era in which we are increasingly speak of democratic accountability, one of the major international organisations, with a tremendous potential effect on the global economy, has been striving hard to reduce its accountability. In effect, it has been waging a campaign to reduce its own direct accountability to democratic processes. These are matters of controversy, but it is a controversy which, unfortunately, has been suppressed for too long."

In response, there has been a change in the thinking of the IMF when it started to communicate with civil society including NGOs and trade unions, especially under the preparation of the Poverty Reduction Strategy Papers (PRSPs). As far as transparency of its operation is concerned, the IMF started publicising country information, Policy Framework Papers, Letters of Intents, Public Information Notices, and Executive Board summaries mostly in its extensive Web Site.<sup>17</sup> In the second half of the 1990s the IMF, reluctantly, also recognised that successful programmes are those that are owned by the loan recipient country. The three reports which the IMF released in 2001 argued the need for refocusing conditionalities that do not conflict with strong country ownership (see

IMF, 2001a, 2001b and 2001c). The programmes must be fundamentally the authorities' own, whereas conditionality is introduced to ensure that the Fund's resources are used for their intended purpose. According to this view, ownership is an essential foundation for conditionality: it is the authorities who decide what policies to adopt, including whether to seek the financial support of the Fund, and it is the authorities that are responsible for implementing the programme.

No matter how many times the IMF reiterates the compatibility of ownership with conditionality; the latter is designed to alter the behaviour of governments with regard to political structures, social practice, and economic strategy. These conditionalities to the highest degree compromise domestic ownership of policies, because a relationship of financial dependency is established through IMF programmes. The IMF enjoys bargaining power over the recipient government, mainly through tranching of credit. Conditionalities, through behavioural modification of the recipient country, establish asymmetrical power relationship based on donorship rather than ownership (Stokke, 1995a). Behavioural alteration through conditionalities is driven by the shareholders of the IMF, which are led by the United States (Taylor, 1997). Conditionalities are precisely reflections of the conflict between the recipient country's objectives and the influence of powerful nations (Killick, 1997). The outcome usually is in favour of the IMF, whose catalytic function and seal of approval give it powerful leverage. For this reason alone, conditional lending erodes ownership of programmes. Taylor (1997, p. 145) point out that "[T]heir [IFI's] emissaries arrive in local capitals with substantial hard currency credit lines in hand – a strong incentive for the authorities to take their proposals to heart."

The IMF's chief shareholders are the "G-7 or more to the point the G-3 or the G-1 made up of the United States only" (Taylor, 1997, p. 150). The U.S. selects the Executive Board and as shown in Table 1.2, the voting share of 44 countries in SSA is well below the share held by Japan, Germany, France, and United Kingdom, while it is a mere 25 per cent of the voting power held by the United States. The IMF does not treat all countries the same and its surveillance of the rich countries has become a "shadowy affair", and in

practice the IMF pressure is on the poorer member countries, especially the debt-ridden developing countries. Singer (1995, p. 13-14) stresses this point:

“Such global management as exists today would be that exercised by the Group of Seven (G-7), the group of the most important Western industrial countries. This is certainly a regression from multilateralism and indeed from democracy. The G-7 only represent 12 per cent of the world’s population, leaving 88 per cent of humankind totally disfranchised.”

**Table 1.2 – IMF Voting Power on April 30, 2002**

<b>Casting Votes of</b>	<b>Total Votes</b>	<b>Percent of IMF Total Votes</b>
<b>United States</b>	371,743	17.60
<b>Japan</b>	133,378	6.16
<b>Germany</b>	130,332	6.02
<b>France</b>	107,635	4.97
<b>United Kingdom</b>	107,635	4.97
<b>Sub-Saharan Africa</b>	95,137	4.39

Source: IMF (2002c)

Towards the end of the 1990s “a new consensus” attacked the Washington consensus, and particularly the IMF.<sup>18</sup> The then influential Chief Economist of the World Bank, Joseph Stiglitz, at the 1998 WIDER annual lecture, formally introduced what is dubbed the “post-Washington consensus” (Stiglitz’s, 1998b). As yet, the interest shown to the “new consensus” is scant, perhaps because it offers no radical alternative nor does it offer a clear policy menu as far as stabilisation and growth are concerned (Sender, 1999, Gore, 2000, and Fine 2001a). The *New Paradigm* according to Stiglitz; “takes its core objective *development, as the transformation of society*. It recognises that an integral part of successful development is increase in GDP per capita” (p. 15).<sup>19</sup> In his recent book entitled *Globalisation and Its Discontents*, Stiglitz (2002) also points out that the IMF forgets the fundamental objectives of development. In fact “[D]ecisions were made on the basis of what seemed a curious blend of ideology and bad economics, dogma that sometimes seemed to be thinly veiling special interests” (p. xiii).<sup>20</sup> As Fine and Hailu (2001, p. 3) argue:

“In effect, the analytical contradictions of the old consensus, which were never exposed let alone addressed, can be set aside by the new consensus to which models underlying IMF financial programming can be interpreted as converging.

In particular, the extent of the IMF's commitment to, and acceptance of, the new consensus will depend upon the extent to which it frees itself from obsessive pre-occupation with financial targets at the expense of growth and other non-financial objectives. For it is only in its analytical origins in the Polak model and in its continuing commitment to financial programming that IMF macroeconomics is obstructed from embracing the "post-Washington consensus". In terms of the old joke, wherever the IMF is going, it would have done better to have started from somewhere else!"

Most countries in the developing world still need external finance to supplement domestic savings. The resource gap or savings gap leads to the emergence of foreign-exchange gaps that must be financed with capital flows from abroad. These flows can take different forms: aid, multilateral credit, commercial bank loans, foreign direct investment (FDI), and portfolio finance (equity and bonds). Since international private financial markets require credit rating, there is a role for the IMF in terms of both financing development and supplementing existing markets. The cycle of capital transfers from the developed to the developing world are now turning full circle. Today increasing attention is played to the role of private finance in developing countries and new mechanisms and initiatives are proposed to increase the flow of funds. This attention has historical roots: many countries are undergoing liberalisation of their economies and are becoming integrated with the global financial system. As long as there is a predictable flow of capital from private sources, the resources from the IMF will only be required in times of crisis in upper- and middle-income countries. This is mainly due to the amount of loans the IMF can advance, the conditionality attached to its lending as well as its low concessionality to upper- and middle-income economies (see Bird, 1999).<sup>21</sup>

It is, however, deceptive to think that the increasing private capital flows reach the least-developed countries. Despite liberalisation of financial systems in most countries of sub-Saharan Africa, the target countries are emerging economies of Asia, Europe and Latin America. Hence, the IMF will continue lending to developing countries, and will have greater influence in the least-developed economies in particular. It is this continuing involvement of the IMF in the developing world, particularly the policies and their outcome, which instigated, and justifies the research in this thesis.

## 1.4 Organisation of the Thesis

The primary focus of this thesis is to trace the evolving macroeconomic theory underlying the stabilisation and adjustment policies of the IMF and identify the missing links in successful structural transformation. The thesis places IMF programmes into three distinct categories. These are: 1) the conceptual framework or design of programmes; 2) the empirical or impact analysis; and 3) the political economy of development. These elements of the literature are brought together to show how, both in absolute terms and relative to concomitant best mainstream practice, the macroeconomic theory and rationale underlying IMF programmes have been inadequate, especially in the context of development beyond low inflation and positive growth. More specifically, it will be shown how IMF programmes have failed to link the short run measures with long run objectives, and how they are totally inappropriate for addressing the issue of structural transformation by setting aside the role of the developmental state. This is done through a study IMF programmes in Ethiopia and Uganda.

The discussion in this thesis is recognisably concerned with approaches to development and the relative influence of internal intellectual developments and of external influences (and the relationship between the two). Both of these factors are important although their relative weight and nature of interaction cannot be taken as fixed. In the context of IMF programmes, distinctions must be drawn between the theory, the ideology and the practice, quite apart from the internal and external influences that are felt on each of them and on their relationship to one another. In some instances, influences are clear, as in the political motives for granting loans, or the incorporation of supply-side policies into programmes. At other times, the path taken is less readily subject to explanation as in the incorporation of particular variables or models one sort rather than another in the case of poverty and governance assessment.

To these conundrums must be added an additional factor – the internal institutional dynamics of the IMF as an institution. We know very little about this, much less than about the World Bank, although the reputation of the IMF for Chicago style



economists is also discerned if not universally uniform. Unlike the World Bank, evidence of internal disputes within the IMF is hard to come by.<sup>22</sup> Consequently the sociology of knowledge of IMF programmes cannot be comprehensively addressed. But it is possible to engage in a broad reading drawing upon the materials that are readily available – the publications of the IMF itself, and the broader literature primarily but not exclusively focused on stabilisation, adjustment, programme design, implementation, impact analysis whether critical or supportive of the IMF. Through such a broad reading, it is possible to avoid simplistic impressions of the IMF and its programmes as good or bad, wrong or right, theoretical or rhetorical or somewhere in-between. Rather IMF programmes can be situated both in terms of their own evolution and in terms of the circumstances.

The literature has grown fast and expanded enormously. It is also widely scattered and potentially involves a huge volume of material. What follows in this thesis is neither a comprehensive discussion of the IMF's various functions, nor even an extensive exposure of its involvement in each and every developing country. The terminologies and concepts used in this thesis are standard in the literature. For instance, stabilisation and FP are the same and refer to the short run; adjustment refers to the long run. IMF programmes are interchangeably used with neo-liberalism and the Washington consensus. The main reference throughout the thesis will be developing countries, with particular emphasis on sub-Saharan Africa (SSA). The coverage of the literature is up to date, but does not cover PRSPs, which the IMF and the World Bank are now requiring to extend further lending and reduce multilateral debt in the least-developed economies.

## **1.5 IMF Stabilisation Programmes**

As such, in this thesis, discussion of the stabilisation and adjustment policies of the IMF falls between two stools. The first is limited in ambition in providing an organised narrative of the theory of FP and the complementary adjustment policies – who said what about what and when. The second is too ambitious in scope and can only be partially addressed in this thesis, mostly as a background theme in the industrial

development – namely why has the scholarly rhetoric of IMF programmes set aside the developmental state literature. A complete answer could have been supplied to the latter if it had conformed to one or other of two polar models. One of these is the notion that, subject to lags, FP has responded to the evolution of knowledge itself whether derived from theoretical advances or experience of FP in practice. This model is readily shown in Chapter 2 to be fallacious since, FP falls for short of best practice both theoretically and empirically. But the distance, as relationship, between FP and best practice does not remain constant. Consequently this relationship needs to be explained.

As illustrated in Chapter 2, the IMF uses its financial programming model to restore macroeconomic balances. The overall objective is, according to the official rhetoric, to foster economic growth, keep inflation low and maintain a sustainable balance of payments. The formal model applied to achieve these objectives is the FP or the Polak model, which emerged out of the monetary approach to the balance of payments (MABOP). The Polak model shows the determination of the balance of payments by using the level of domestic credit as a key policy variable. This is demonstrated by a mix of accounting frameworks and behavioural functions for the demand for money and the demand for imports. The model leads to a fundamental conclusion that when the level of domestic credit (mainly to finance government deficits) exceeds the demand for money, the extra spending will be spent on imports causing deterioration in the balance of payments. The primary focus is on maintaining internal and external macroeconomic equilibrium. Internally, the disequilibrium is between government revenue and expenditure, whereas external imbalances refer to the disequilibrium between imports and exports. And when an economy exhibits these imbalances, corrective measures must be taken. What is commonly known as stabilisation prescribes remedial policies, mainly fiscal, monetary and exchange rate policies to restrict demand for local as well foreign good. The impact of exchange rate changes, mainly through the real balance effect or in reducing domestic absorption, are central to the stabilisation process (IMF, 1987 and IMF, 2001a).

However, FP-based stabilisation, which is mainly concerned with austere credit restraint, undermines social objectives as well as damaging the productive capacity of developing economies. For the Polak model to work, the increase in output will not be spent on extra investment and capacity. The model has a fixation with monetary variables or the exchange side of the economy, ignoring the implications of the short run on the long run and constructs unrealistic dichotomies between the exogenous and endogenous variables. The production side of the economy is completely ignored, while there is no place for explaining how firms emerge, how technologies are acquired, how industries mature, and what role governments play in the process of development. There is also no place for productive capacity in the realm of firm-specific knowledge, differentiated products, patents, scale economies, externalities, research and development (Amsden, 1997 and Taylor, 1997). IMF programmes fail to recognise that mainstream macroeconomic policy prescriptions produce non-standard results when applied to less-developed countries (LDCs). Monetary restriction and devaluation lead to both recession and inflation (Porter and Ranney, 1982 and Taylor, 1981, 1988, 1997). Application of standard IS/LM analysis to aggregate demand, where equilibrium between the flow of current output and stock of money is established, must also be different in developing countries. (Green, 1986).

The burden of cuts in public expenditure often falls on investment in health, education, infrastructure and food subsidies, rather than consumption (Cornia *et al.*, 1987). Fiscal austerity for macroeconomic balance does not take into account high return investments that compensate deficits in the long run through increases in tax revenues (see Alesina and Perotti, 1996 and Addison and Ndikumana, 2003). No account is taken of the fact that credit expansion may be linked through policy with investment and capital accumulation (Tarp, 1993). The demands of human development and cautionary prudence of financial conservatism are contradictory. Financial conservatism becomes less important when faced with key development questions in countries where economic and social deprivations are deep-rooted (Sen, 1998).

## 1.6 IMF Adjustment Programmes

The original Polak model has been retained because of the imperative of financial balance for the IMF. However, in response to the long-standing criticisms, the FP package evolved from an essentially short run model to one that deals with long run supply-side issues. This raises the following questions. First, what triggered the extension of IMF programmes from demand-side into supply-side? And what are the theoretical bases for the supply-side or adjustment package? Towards the mid-1980s the IMF began to show a widespread interest in supply-side issues. This was motivated by the fact that many observers in the profession highlighted the existence of lags in responses and underlying distortions in developing economies (see Khan *et al.*, 1991 and Schadler *et al.*, 1995). According to Khan and Sharma (2001, p. 20), the drive towards extending the FP model came about because:

“In the late 1970s and early 1980s, the IMF was criticised for being interested only in narrow (balance of payments) outcome and relatively unconcerned about growth. Thus the IMF, in response to calls by its membership, began to include programmes and policies to remove structural impediments to growth and the efficient allocation of resources”

But how IMF programmes have been disaggregated and behavioural equations incorporated owe as much to a selective reading of external theory as to internally generated imperatives, mainly the neglect of structural change. Initially what was a Polak model was transformed into a financial programming framework by bringing in variables through disaggregating and with a more behavioural approach in response to data problems and criticisms, ultimately leading to a “comprehensive stabilisation model”. Chapter 3 shows how the IMF extends its FP framework from that of short-term stabilisation to medium- to long-term adjustment objectives. The first is to merge the IMF’s FP model with the World Bank’s Revised Minimum Standard Model (RMSM) (Khan *et al.*, 1990). The adoption of adjustment and structural policies by the IMF facilitated the joint operations and the “marrying” of the IMF with the World Bank (Khan and Montiel, 1989 and Khan *et al.*, 1990). The idea behind formulating a merged model

is to address limitations of the two models. The merged model endogenised real output, which the FP model does not, and also determines prices, which the RMSM does not.

It is evident from the policy conclusion of the merged model that it falls short of satisfying the continuing theoretical deficiencies and inconsistencies. Polak (1997) himself is sceptical about the value of the “marriage”, rendering it inappropriate for addressing transition and development. He is also sceptical about the extent to which the model can be extended over time or to other policy objectives other than through reiteration of guesswork concerning macroeconomic approximation. Effectively, stabilisation has been designed around a zero growth rate or an unstable growth path, neither of which, surely, is acceptable as the basis for policy making for any, let alone a developing economy (Fine and Hailu, 2002). As Polak (1997) notes:

“it is curious that for their medium-term macroeconomic projections both the IMF and the World Bank continue to rely on highly mechanical growth models of the Harrod-Domar family, first developed in the late 1940s. In these models there is no place for what the two institutions themselves consider the most important factors determining the growth of developing countries, such as outward orientation, realistic prices, privatisation, reform of the financial sector, and, in general, government attitude toward the economy” (p.18)...“In a formal sense, it would not be particularly difficult to introduce these three extensions into the model. But that would be essentially useless unless it were also possible to obtain some order of magnitudes of the coefficients for the variables in the newly introduced equations. And that, unfortunately, is not possible. In this setting, the IMF has had to forgo the comfort of its own model and base its conditionality on a set of ad hoc instruments that seemed plausible in the circumstances” (p. 18).

The second extension of IMF adjustment programmes heavily relies on developments in the profession to derive distortion-removing policies. The theoretical framework is provided by mainstream neoclassical economic thought and is added to the stabilisation package in a piecemeal and *ad hoc* fashion. This is clearly discerned as the macroeconomics of the IMF uses trade and financial liberalisation, price deregulation, and privatisation to restore equilibrium or reduce deviations from it, which are extensively discussed elsewhere in the literature (Goldstein, 2000). For the purpose of this thesis, Chapter 3 will provide brief outlines for some of these policies. It does not

enter into detailed presentation of the models, as the objective is to show how the IMF responded to the critique of FP by drawing on mainstream supply-side economics.

The *ad hoc* inclusion of adjustment policies focused on financial liberalisation along the hypothesis laid by the financial repression models of McKinnon (1973) and Shaw (1973). These models propose that allowing real rates of interest to rise to their market clearing level stimulates higher savings and investment, both through raising the average efficiency of investment and by enabling rationing of low-yield investment projects (World Bank, 1989b and Fry, 1997). The foundations for the financial liberalisation hypothesis are weak (see Gibson and Tsakalotos, 1994 and Agénor and Montiel, 1996 for review of the literature). Saving and investment do not always equate and a rise in the former does not necessarily imply increased investment. Investment depends on expectations of future demand and prices, which are determined by social conflicts and the resulting income distribution (Burkett and Dutt, 1991). The market also reflects the actions of banks, consumers, savers, investors, trade unions, government departments, and relationships and trust among these institutions is what reduces information costs and uncertainty (Soskice, 1991 and Patrick, 1996). The assumption of the auctioneer and the absence of institutions are major deficiencies of the financial liberalisation model (Stiglitz and Weiss, 1981 and Stiglitz, 1989, 1993). It also fails to address the particularities of community based local networks and traditional familial relationships within grassroots financial transactions (Aryeetey and Nissanke, 1998).

The IMF adopted trade liberalisation based on the idea that countries would benefit from maintaining their higher share in world trade (Ranis, 1985 and Helpman and Krugman, 1985). This implies that high cost and low productivity economies will fall short of reaping the gains from trade (Krueger, 1993a and Krueger, 1998a). Thus, the IMF encourages trade regimes that usually include the adoption of a low, uniform tariff structure, which provides equal effective protection to all producers of tradable. However, there are no significant impacts of trade liberalisation on export performance and the limit of trade liberalisation is its neglect of structural features (Shafaeddin, 1994; Harrison and Hanson, 1999; and Thirlwall, 2000). A recent survey of the empirical

literature has shown that the direct link between trade liberalisation and economic growth is ambiguous, mainly due to suspect methodology and confused econometric analysis (Rodríguez and Rodrik, 1991 and 2001). The success of openness depends mainly on how comparative advantage is aided by other sector-specific policies. Examples are research and development expenditure, technological advances, and improving quality of products (Amsden, 1997; McKay *et al.*, 1997; and Winters, 2002).

Currency depreciation is at the core of IMF supply-side programmes based on the idea that it increases the domestic currency price of exports, increases foreign demand for exports, and raises the domestic demand for and supply of import substitutes (Bird, 1983 and IMF, 1987). Another argument for devaluation is elimination of rent-seeking and wasteful administration activities typically encouraged by overvalued exchange rates and the associated import licenses and exchange controls (Krueger, 1974). Overvaluation of the exchange rate is blamed for inducing capital flight due to anticipation of further devaluation (Sachs and Larrain, 1999 and Shatz and Tarr, 2002). Exchange rate overvaluation affects productivity gains and hence growth negatively (Edwards, 1989 and Cottani, *et al.*, 1990). However, the assumption that exports and imports are responsive to prices so that capital and intermediate goods could be substituted without causing disruptions in investment and output is unrealistically based on perfect mobility of factors of production. The structural rigidity or inflexibility of developing economies is not taken into consideration (Taylor, 1993b). There is also danger of a fallacy of composition effect in manufacturing (Cline, 1982 and UNCTAD, 2000) as well as agricultural exports (Bleaney, 1993; Akiyama and Larson, 1994; Schiff, 1995; and Weeks, 1995).

The fourth supply-side policy, which the IMF embraced, is privatisation. The objectives are to foster private sector participation, improve the efficiency of enterprises, and create a competitive environment, and improve the government's fiscal position (Cambell-White and Bhatia, 1998). Public choice, property rights and principal-agent theories provide the justification to pursue the transfer of public assets to the private sector (Vickers and Yarrow, 1991 and 1995). However, theories of privatisation are unduly pessimistic about the motivation of state run enterprises, which often guarantee

access to basic services by low-income groups. The experience of privatisation suggests that there is no evidence that ownership by the private sector is superior over ownership by the public sector as far as efficiency of enterprises is concerned (Berg and Shirley, 1987; Chang and Singh, 1993 and 1997).

The *ad hoc* appropriation of neoclassical supply-side economics and the attempted “marriage” are meant to extricate IMF programmes from the bondage of FP, which is short term and monetarist, and enter into long run supply-side eclecticism. It is evident that these models fall short of addressing the theoretical deficiencies as well as inconsistencies as regards target and instrument variables within the FP framework (Fine and Hailu, 2002). This is consistent with neoclassical theory in which macroeconomics is treated as a general equilibrium theory with the addition of the monetary sector. Such mixing of short-term demand-side and long-term supply-side policies provided the IMF a strong weapon while at the same time damaging the potential for meaningful development in the countries where these policies are implemented. As Kapur (1998 p.128) aptly put it;

“Today, the principles for which the IMF claims to stand are increasingly at odds with the way in which it conducts its own affairs. It promotes the virtues of democracy-while deeming them impractical, if not downright dangerous, for multilateral governance. It derides and discourages state intervention in economic affairs-while insisting on its right to restructure from top to bottom the economies of the LDCs. And it rejects the need for international controls on capital as invidious - while asserting the need for those on labour to be obvious. This welter of contradictions serves to highlight the corrosive impact of a long series of ad hoc solutions on an increasingly dilapidated system of global governance.”

## 1.7 The Impact Analysis

The empirical evidence lying at the other extreme to analytical posturing does not strongly support IMF programmes. This suggests that FP in theory is simply a consequence of the need to serve in the form of a rationale for IMF programmes in practice. Indeed, what is striking is the extent to which there is a distance between theory and practice. Also this distance, or relationship, between the two has changed over time



and so must be explained though methodological weaknesses. An influential recent report pointed out that IMF programmes are not associated with increased growth performance (Meltzer, 2000), while others argue to the contrary (Khan and Sharma, 2001 and IMF, 2001a). The difficulty of measuring the counterfactual (i.e., what would have happened in the absence of IMF programmes) remains a key methodological problem (Guitian, 1981; Williamson, 1983c; Goldstein and Montiel, 1986; Conway, 1994; Khan and Ul Haque, 1998). The specific impact analysis techniques also suffer from methodological shortcomings. The before-after approach ignores exogenous factors that may affect the pre- and programme periods; the with-without approach does not take account of the characteristics of non-programme countries; the actual vs. target approach has a bias against programmes because targets may not be achieved, for example, due to incomplete programmes and unfavourable external factors; and the regression and structural model approaches only show statistical relationships between target and instrument variables and assume parameters stay constant over time.

A fresh review of the empirical literature in Chapter 4 comes up with three broad conclusions. First, only 35 per cent of the studies found a positive impact of IMF programmes on growth. Second, only 49 per cent found a positive impact on the current account. Third, only 41 per cent found a positive effect on inflation. Fourth, many studies show programmes were not fully implemented. It has been found that 50 per cent of Stand-by arrangements, 85 per cent of EFFs and 38 per cent of SAFs were uncompleted (Killick, 1984a and 1995a). Conway (1994) also finds that 50 per cent of programmes were uncompleted, while Mussa and Savastano (1999) find 34.8 per cent of IMF programmes were interrupted. The results also indicate that most of the programmes were uncompleted in Africa and Latin America. Non-adoption is attributed to negative external environment, such as unfavourable terms of trade (Edwards, 1989; Polak, 1991; Killick, 1995a; and Mussa and Savastano (1999) as well as severe conditionalities (Kapur, 2001 and Goldstein, 2000 and 2003). But, the IMF insists, “the data provide no indication that more conditionality impairs implementation” (IMF, 2001a, p. 21) and “most programme interruptions have been the result of factors outside the funds control - that is, *major political upheavals and flagging commitment*” (IMF, 2001a, p. 56 italics added).

According to a recent IMF working paper, “ethnic and linguistic divisions, strong special interests, and lack of political cohesion contribute to programme failure” (Anayiotos, *et al.*, 2001, p. 2). The message is programmes work but political factors impede their success.

Besides programme interruptions, some other important issues are identified from the review of the impact studies in Chapter 4. The first problem is related to the problem of using annual data while IMF programmes start at any time of the year. The second is related to arbitrary use of 0-1 dummy variables for the absence and presence of IMF programmes. The use of a binary one-zero index does not reflect implementation of programmes. Programmes may be scheduled at 6-month frequencies and waivers may be granted to permit purchases even when implementation slips. Programme effects must not necessarily follow a linear path, and increases in some variables may be offset by decline in others, which cannot be captured by a simple search for percentage increments in target variables (Bird, 2001). Third, an assessment of programme impact is precisely an evaluation of the IMF’s as well as policy makers’ knowledge of the economy. Full grasp of economy-wide relationships is unlikely in the face of data problems and paucity of economic analyses, particularly in low-income economies. Fourth, the studies report success and failure on the basis of statistical significance or otherwise. Significance tests based on t-statistics do not tell us much about economic significance in terms of concrete development outcomes such as improved earnings or structural transformation. Fifth, the impact studies tell us nothing about the cost of improvement in the rate of growth and the balance of payments, as these are often achieved by severe deflation. The short run damage may have a longer than expected effect on productive capacity.

Survey of the impact literature also reveals that there is evidence of repetitive lending to the same countries, what is called “recidivism” (Bird, 2001). The rate of repetitive lending is high to economies with serious difficulties, with a probable inference that new programmes had to be prescribed because earlier ones failed. Other findings also confirm that IMF lending goes to countries favoured by the U.S. The impact of IMF programmes seems to be that U.S.-friendly countries are locked into a vicious cycle of

economic decline and IMF programmes, without any concrete development. It becomes clear that the impact analysis is not taken seriously either as an appropriate way of assessing effect of programmes or responding to criticisms. To use a medical metaphor - there is no feedback from results of treatment to new or continuing patients.

## 1.8 IMF Programmes in Ethiopia and Uganda

The cross-section impact literature indicates that IMF programmes at best have unfavourable outcomes. Applying the before-after and with-without approaches to Ethiopia and Uganda, Chapter 5 concludes that IMF programmes did not meet their stated objectives nor are these objectives sensible in terms of concrete economic development.

Ethiopia and Uganda are two of the countries in sub-Saharan Africa, which adopted eight IMF programmes between 1987 and 2004. The 1987 stabilisation and adjustment programme in Uganda was initiated after the National Resistance Movement (NRM) under Yoweri Museveni overthrew the Obote II government in 1986. Since then the IMF and the World Bank identify Uganda as a model of successful reformer. The government's handling of the economy is widely regarded as a success story that earned it the name the "show case" (Ddumba-Ssentamu, *et al.*, 1999). In Ethiopia, the *Dergue* regime (1974-1991) resorted to central planning, which has been the dominant thrust of economic strategy. In May 1991, the regime was thrown out of office by a coalition of ethnically demarcated opposition fighters under the name of the Ethiopian People's Revolutionary Democratic Front (EPRDF). Consequently, Ethiopia signed a SAF agreement with the IMF in 1992 and began implementation of stabilisation and adjustment programmes. Both countries devalued their currencies, liberalised foreign trade, opened up the financial sector and privatised state-owned enterprises.

There are some grounds for the argument that Uganda and Ethiopia are successful reformers. The statistical results demonstrate that the effect of IMF programmes on real GDP per capita and real GDP growth rates is significant in the initial three years under

SAF programmes compared to the previous three years. Nonetheless, growth rates for both countries were no better than countries that did not adopt IMF programmes (Botswana, Namibia, Seychelles, and Sudan are used here as benchmarks for with- without comparisons). Uganda reduced its high rate of inflation in the second ESAF programme after six years under IMF programme. Ethiopia's inflation rate is significantly reduced compared to the average for countries without IMF programmes, but Ethiopia always had historically low inflation rates. The current account deficit for Ethiopia and Uganda showed no significant improvement under IMF programmes. In some years the current account deteriorated under IMF programmes. These programmes have had positive and significant impact on the reserve holdings of both countries, but these improvements are not statistically different from those observed in Botswana and the countries without IMF programmes. Countries that did not implement IMF programmes actually performed better and improved their external sectors.

The empirical results in Chapter 5 also show that no significant difference was observed in the flow of domestic credit to government or in fiscal deficits before and after programmes. IMF programmes were associated with significant real exchange rate depreciations for both Ethiopia and Uganda, while liberalisation of the financial sector in Uganda led to real positive interest rates, but not in Ethiopia. These results indicate that IMF programmes were not *fully* implemented in Ethiopia and Uganda. Moreover, programme completion is not correlated with performance. We find cases where target variables improved even though programmes were not completed and deteriorated where programmes were completed.

There is limited and partial evidence to imply that Ethiopia and Uganda fared differently from their pre-reform economic state or performed as or better than Botswana, Namibia, Seychelles, and Sudan, which never implemented SAF, ESAF and PGRF programmes. The question is: what do improvements in growth rates and international reserve holdings mean in transforming the two economies in question? The answer is simple: behind the seemingly attractive statistics lie economies with negligible structural transformation measured as share of manufacturing output in national income. There is

nothing to differentiate Ethiopia and Uganda from their pre-reform economic predicaments as well as from countries which did not implement IMF programmes. A test of structural transformation shows that despite recidivism the Ethiopian economy de-industrialised while Uganda industrial sector stagnated. These conclusions are supported by results which illustrate that the share of manufacturing in GDP declined by 1 per cent for Ethiopia, comparing the years with IMF programmes with those without. The 1 per cent increment for Uganda is significant only when compared to the late 1970s and early 1980s, which saw sharp declines in the share of manufacturing.

## **1.9 The Developmental State is the Missing Link**

Structural transformations took place in other parts of the world, particularly East Asia as a direct result of state intervention. Chapter 6 argues that the missing link in countries such as Ethiopia and Uganda is the developmental state, which would mobilise finances, create state-society relations for selective credit, subsidies, protection, and other industrial policies. The central argument in this thesis is that the failure of IMF-programmes to bring about meaningful development is because the rationale underpinning it sets aside the developmental role of the state, despite conclusive evidence that it has contributed to industrialisation in other parts of the world. Indeed there is a theoretical, historical and empirical case for state intervention to guide structural transformation.

The East Asian developmental states were successful in achieving rapid growth not least the state mobilising finance and because of state-society relations that allowed for selective credit, subsidies, protection, and other industrial policies. East Asian industrialisation is a result of the state's stimulating capital formation to accelerate structural change under a state-corporatist system of "governing the market" (Wade, 1990), complemented by acquisition of technology and infant industry protection (White, 1988; Hoogvelt, 1990; and Chang, 1993). A capable, independent and committed bureaucracy that forged productive relationships with especially favoured capitalists

implemented these non-orthodox policies. Through such relationships the state was able to grant selective credit, tax incentives, public-private investment partnerships, high government funded research and development, conflict resolution between capital and labour, and simple and quick administrative decisions (Johnson, 1982 and 1999). Whilst it is important not to over-generalise, the notion of the developmental state has usefully been exported to other East Asian countries, particularly South Korea, Thailand, Taiwan, Singapore and Hong Kong. At the same time, the prevailing international political economy made it possible for South Korea and Taiwan, as satellite nations of the U.S., and Japan a significant ally during the cold war, to pursue a mix of state-led and market-led policies, mainly because of U.S. tolerance to “distortions” (Evans, 1987; Woo, 1991; Kim, 1995; and Lukauskas, 2002).

Four elements marked the emergence of anti-state, neo-liberal ascendancy from the early 1970s. First, it combined ideological supremacy and the financial backing from industrialised countries. Second, denial of the East Asian state-driven industrialisation provided the platform to argue for dis-engaging the state. Third, based on the impossibility for the emergence of the developmental state in SSA, the Washington consensus concocts a case for a minimalist state vis-à-vis stabilisation and adjustment programmes. These three elements are explicit and abound in the literature. The fourth element is subtler and is closely related to the impact of IMF programmes. This thesis contributes to the literature by highlighting that the IMF’s use of state-society relation as explanation for failure and non-adoption of its programmes has been used to vindicate failure of IMF programmes as well as adding to the three elements of the anti-state stance described above. The inconclusiveness of the impact analysis as well as the findings of the two country case studies clearly demonstrate that there is a missing link in IMF-supported stabilisation and adjustment programmes. By advocating new political theories, which divide society into competing interests, the Washington consensus consistently searches for a way out of its dilemma: added to its usefulness to vindicate programme failure, blaming interventions as causes of economic crisis provides an extra justification for de-linking the state. A fourth dimension is added to already established reasons for excluding state-led strategies.

This represents a warm embrace of a rationale offered to the IMF by external developments within the fields of political science. It has allowed its traditional lack of interest in programme results, other than *ex post* rationalisation with weak empiricism, to be sustained. A contrast can be drawn with the cosier reception to the goal of high income and employment, other than in rhetoric, and the token confrontation and incorporation of the voluminous literature on supply-side economics. This additional justification to de-link the state has built the capacity of the state in a paradoxical way. Its strength was needed to carry out the unpopular stabilisation and adjustment policies, its capability to emulate the developmental state through mobilising finance, providing incentives and protection has been curtailed. Often implemented by means of repressive actions to counter public opposition, IMF programmes nurture a new form of dependency, one based on stringent conditional finance, pushed through by a powerful political hegemony with little tolerance to markets “distortions”.

Viewed critically, the common feature of IMF programmes is that they lag best practice in terms of the theoretical work, sophistication of impact analysis, range of policy objectives, and assumptions over political economy of development. However, by the same token, it is not possible to be sanguine about the prospects for such critical appraisal from whatever quarter to have a major impact on the thinking of the IMF itself let alone its policies in practice. For, to the extent that these are relatively independent of one another, criticism can be incorporated by the IMF with the result of strengthening the rationale offered for otherwise unchanged policies, circumventing rather than incorporating critical insights. In future research, it will be interesting to see how PRSPs have been incorporated within the IMF models. Ultimately then, the contribution of the thesis rests on adding to the field of knowledge an integrated analysis of IMF's conceptualisation of development. As such, it does not otherwise seek to offer an alternative general basis for macroeconomic stabilisation and adjustment for developing countries. Indeed, it is to be suspected that such a goal is futile given the specificities of different countries across time and place. Possibly more than anything else this explains

the divorce between the theory and practice of stabilisation and adjustment irrespective of the questionable events of each.



### Appendix 1: IMF Facilities<sup>23</sup>

*Poverty Reduction and Growth Facility (PRGF):* The IMF for many years provided assistance to low-income countries through ESAF. In 1999, however, a decision was made to strengthen the focus on poverty, and the ESAF was replaced by the PRGF. The interest rate levied on PRGF loans is only 0.5 percent, and loans are to be repaid over a period of 5½-10 years.

*Structural Adjustment Facility (SAF) and Enhanced Structural Adjustment Facility (ESAF)* are set up in March 1996 and December 1987, respectively. These are highly concessional loans to support macroeconomic reforms in low-income countries. The expected duration of the programmes supported was 3 years, and the repayment period was 5½-10 years. Members announce their reforms in policy framework papers and the conditionalities were mainly bi-annual structural performance criteria.

*Stand-By Arrangements (SBA):* The SBA is designed to address short-term balance-of-payments problems and is the most widely used facility of the IMF. The length of a SBA is typically 12-18 months. Repayment is expected within 2¼-4 years unless an extension is approved. Surcharges apply to high levels of access.

*Extended Fund Facility (EFF):* This facility was established in 1974 to help countries address more protracted balance-of-payments problems with roots in the structure of the economy. Arrangements under the EFF are thus longer (3 years). Repayment is expected within 4½-7 years unless an extension is approved. Surcharges apply to high levels of access.

*Supplemental Reserve Facility (SRF):* The SRF was introduced in 1997 to meet a need for very short-term financing on a large scale in response to loss of market confidence experienced by emerging market economies. Countries are expected to repay loans within 2-2½ years, but may request an extension by up to six months. All SRF loans carry a substantial surcharge of 3-5 percentage points.

*Contingent Credit Lines (CCL):* The CCL differs from other IMF facilities in that it aims to help members prevent crises. Established in 1999, it is designed for countries implementing sound economic policies, which may find themselves threatened by a crisis elsewhere in the world economy—a phenomenon known as “financial contagion.” The CCL is subject to shorter repayment terms than the SRF, and carries a smaller surcharge of 1½-3½ percentage points.

*Compensatory Financing Facility (CFF):* The CFF was established in the 1960s to assist countries experiencing either a sudden shortfall in export earnings or an increase in the cost of cereal imports caused by fluctuating world commodity prices. The financial terms are the same as those applying to the SBA, except that CFF loans carry no surcharge.

*Emergency Assistance:* The IMF provides emergency assistance to countries that have experienced a natural disaster or are emerging from conflict. Emergency loans are subject to the basic rate of charge and must be repaid within 3¼-5 years.

*Source: IMF (2002d)*

## Notes

<sup>1</sup> The depression of the 1930s led to the collapse of the gold standard. Following the international monetary chaos, the IMF became the protector of the new fixed exchange rate regime. The initial negotiations at Bretton Woods focused on granting a supervisory role to the IMF on all countries symmetrically, while it was possible to detect greater emphasis on surplus countries. This had much to do with Keynes' own previous work. For instance, Keynes proposed a tax on surplus countries and a liquidity of 50 per cent of world imports. The first proposal was rejected and the second was reduced to 18 per cent (Krueger, 1998b).

<sup>2</sup> The 1944 Bretton Woods Conference also discussed the creation of the International Bank for Reconstruction and Development (IBRD) or the World Bank, established to facilitate the flow of official financing to those countries that had low saving rates but which guaranteed high rates of return to investment. The World Bank also financed reconstruction programs in many countries. The Bretton Woods Conference also conceived the creation of the International Trade Organisation (ITO) and the United Nations (UN) as the pillars of the post war economic order. The ITO was created after three years following the conference in Havana. The UN was established at San Francisco in 1945 (Singer, 1995).

<sup>3</sup> The post war currency exchange system resulted in fixing of the price of gold and in turn pegging other currencies to the dollar. This system known as the Bretton Woods exchange rate system became dominant in the late 1950s and throughout the 1960s until its collapse in 1971 after the closing of the "gold window" by President Richard Nixon (Bordo, 1995). The Bretton Woods system was a fixed exchange rate system in which the value of a currency was tied to a dollar. The value of the dollar was in turn linked to gold at a fixed rate of US\$35 an ounce. The system was formally known as the Gold Exchange Standard. What was unacceptable to the financial authorities in the U.S. was that the increase in the price of gold could only be matched by devaluation of the dollar (Aldcroft and Oliver, 1998). The refusal to devalue the dollar meant the price of gold remained fixed despite the increase in the cost of producing it. As a result the supply of gold could not finance the growing volume of world trade. The first problem was that central banks ran out of liquidity. The response was to substitute gold by other assets to maintain a healthy reserve holding. Another option was to allow the IMF to increase its lending. Many countries, however, chose to use the dollar and pound sterling as both the U.S. and the UK ran balance of payments deficits. The second problem was loss of confidence. Too many dollars in the foreign exchange market signalled the likelihood that the dollar might be devalued, sending fears among central banks that held reserves in dollars. The success of Japan and Germany in the export sector further made the dollar relatively overvalued. With its trade deficit the US and hence the Bretton Woods system lacked adjustment mechanisms (Eichengreen, 1996)

<sup>4</sup> Multilateral development assistance was a key responsibility assigned to the International Financial Institutions (IFI's). In the 1950s and 1960s the attempt was made to promote development through execution of large-scale projects with high rates of return. Such project-based assistance was, however, soon to encounter its own problems. First came the scale-up problem: it turned out that most of the large-scale infrastructural programs could not be replicated. Second is the issue of fungibility: external assistance replaced local investment in projects, which recipient governments would otherwise have financed from domestic sources

without external assistance. Hence, donor money financed marginal investments and not the actual project (Collier, 1998a).

<sup>5</sup> See Williamson (1983a and 1983b) for an earlier account of IMF conditionalities.

<sup>6</sup> Mosley *et al.* (1991) point out that staff within the Bank influenced the shift from project lending to programme lending. Pre-programme lending was a period in which engineers had influence and the programme lending in which economists sceptical of project lending take over. The economists disliked the macroeconomic environment in which projects operate, emphasised the fungibility problem and the scarcity of supplementary funding from the recipient country.

<sup>7</sup> The objectives of imposing conditionalities as summarised by Collier and Gunning (1996), are: 1) paternalism, which implies the IMF knows what is best for the country; 2) bribery for adopting reforms; 3) restraint on policy reversal; 4) signalling for financial flows from other sources; 5) monitoring for donor tracking of their finances; and 6) support to reforms.

<sup>8</sup> Lane and Phillips (2000, p. 4) note that moral hazard is a;

“feature of insurance and other forms of risk sharing. It rises when the provision of insurance increases the *probability* of the event being insured against, usually because it diminishes the incentives for the insured party to take preventive actions. Any insurance entails moral hazard when the behaviour of the insured party can influence the probability of the event insured against *and* there is either asymmetric information or some other reason the insurer cannot respond fully (by adjusting terms or cancelling coverage) to behaviour that leads to an increase in the event’s probability.”

<sup>9</sup> The amount of the moral hazard or the benefit to borrowers can be calculated as a difference between the interest rate at which the country purchases from the IMF and the commercial interest rate. The argument also applies to private creditors who over lend to countries in anticipation that the IMF will intervene to rescue. According to Bird (1999);

“Moral hazard would not be a problem if there was uncertainty surrounding the probability of an IMF bailout; foreign lenders would then need to factor this into their risk calculations. However, recent evidence from Latin America and East Asia suggests that the probability of substantial IMF lending in the event of a crisis is very high for countries that are globally significant. So has the IMF almost unwittingly encouraged excess commercial lending and thereby contributed to causing the very crises that it then seeks to overcome?” (p. 965)...The IMF’s existing *modus operandi* does little to help avert crises. But can it help when they happen?” (p. 967).

An important question is posed by Lane and Phillips (2000, p. 3): “how important is any moral hazard created by the Fund in influencing borrowing countries’ and lenders’ behaviour before a crisis?” The authors test for the extent of moral hazard through indicators of market expectations of the IMF’s actions and conclude that IMF financing may lead to moral hazard but as a cause of crisis in emerging markets is unduly exaggerated.

<sup>10</sup> Conditionality was so detailed in Thailand, Indonesia and Korea that the IMF recommended changes in the price of gasoline and in the plywood market (Feldstein, 1998).

<sup>11</sup> More conditionality is said to have a “synergy” effect where “extensive conditionality fosters implementation by creating a critical mass that facilitates progress in related areas and helps rally support for the reforms as they begin to show tangible effects” (IMF, 2001b, p. 72). The IMF argues, however, that the empirical evidence does not support the synergy hypothesis.

<sup>12</sup> See Ferguson (1988).

<sup>13</sup> See Mussa (1997) on the IMF’s surveillance activities.

<sup>14</sup> Giannini (1999) notes that “the better the credibility-enhancing service of the IMF are, the less member countries need to rely on highly visible but sometime problematic tools, such as exchange rate pegs, to discipline domestic policymaking” (p. 4).

<sup>15</sup> Greater transparency was sought at the IMF in relation to the East Asian financial crisis (Fischer, 1999).

<sup>16</sup> According to Scholte (1998, p. 5);

“academic institutions and business associations have tended to have the easiest access to the IMF. Trade unions have generally occupied second place. Religious groups (mainly Christian), development NGOs, and environmental NGOs have generally come third. Meanwhile, many and other potential—and potentially helpful—groups in civil society have had almost no dialogue with the IMF; these have included, among others, smallholder organizations and women’s movements. Other inequalities in the IMF-civil society dialogue have favoured associations based in the North over groups located in the South. Likewise, organizations based in urban areas (especially capital cities) have generally had greater access than groups in rural areas.”

<sup>17</sup> This has begun with the IMF’s then Managing Director, Michel Camdessus’, address to the World Congress of the International Confederation of Free Trade Unions (ICFTU) and the World Confederation of Labour in 1996 and 1997, respectively. Among the recommendations to improve IMF’s relations with civil society are: 1) clarify its objectives; 2) gather more information; 3) consult more with other multilateral agencies; 4) release more documentation; and 5) integrate a “civil society official” into selected country teams (Scholte, 1998, p. 3). The IMF also increased its country resident representation from 20 to 68.

<sup>18</sup> Emergence of a “new consensus” has prematurely been heralded by Singer (1997) who argued that the “pendulum is swinging back” to some form of Keynesian thinking in the development discourse. Singer is obviously referring to the post-Washington consensus and notes that as far as the debate is concerned there is;

“no known method or firm empirical basis for an accurate comparison of government failure vs. market failure. There may be a noble prize waiting for someone who invents such common scale! In terms of policy, this may not matter all that much: both schools could agree that it is important to improve both government performance and market performance. Today the pendulum seems to

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be swinging back to such an intermediate position" (p. 293)...away from the Washington Consensus, although not necessarily directly back to a new Keynesian Consensus" (p. 295).

<sup>19</sup> Stiglitz (1998b) also adds;

But this is only part of the story, and even this will not be achieved unless the country adopts a broader development focus. If successful, the new development strategy will not only raise GDP per capita, but also living standards, as evidenced by standard of health and literacy. It will reduce poverty-our goal should be its elimination, a goal that the more successful economies have actually attained (at least by the *absolute* poverty standard). It will be sustainable, strengthening the environment" (p. 15).

<sup>20</sup> As Sender (1999) notes;

"the post-Washington consensus" is based on the old aggregate production function and did not divorce itself from the Washington consensus' core analytical approach; the "post-Washington consensus" remains wedded to an analytical framework that ignores the specific role of the manufacturing sector in economic development" (p. 107).

This point is also stressed by Fine (2001a) who notes that although the "post-Washington consensus" broadens the development objectives, it is merely based on the existing market imperfection theses with imperfect information added as another form of market failure. Its wide coverage of development objectives is done;

"by completely by-passing all criticism of its predecessor that is not based on an approach tied to its own understanding of market imperfections, and it precludes such approaches as alternatives for future perspectives...its intellectual narrowness and reductionism remain striking, for it replaces an understanding of the economy as relying harmoniously on the market by an understanding of society as a whole based on (informational) market imperfections" (p. 4).

<sup>21</sup> According to Boughton (2000) the first role of the IMF as crisis averter came in 1956 during the Suez crisis. There was fear that the closing of the Suez Canal would bring a financial crisis after the Egyptian government's nationalisation of the canal and when Britain, France and Italy began a military campaign. Boughton notes;

"what is most striking about the late 1960s, viewed from the perspective of the late 1990s, is that the role of the IMF was confined to the realm of economic policy and was linked only indirectly to events in financial markets. At no point was the IMF involved in the effort to stabilise the gold market, but it did play a crucial role in convincing the British and French governments that they could no longer escape devaluation, in evaluating the size of the required parity changes, in helping to design the accompanying adjustments to macroeconomic policies, and in providing large credits until the new policy regimes could take hold" (p. 282).

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<sup>22</sup> These issues for World Bank are discussed in Fine (2001b) and others in Gilbert and Vines (2001).

<sup>23</sup> In the early to mid 1970s, the IMF introduced special financing arrangements under the Oil Facility (OF), the Supplementary Financing Facility (SFF) and the Trust Fund (TF)' all of which are mainly designated for developing countries.

# Chapter 2

## IMF Stabilisation Programmes:

### Demand-Side Policies

#### 2.1 Introduction

The conceptual framework associated with IMF financial programming, pioneered by those who researched under the “monetary approach to the balance of payments” (MABOP), can be thought of roughly as relationships between domestic credit expansion, income and the balance of payments. The framework establishes a direct link between the domestic component of the money supply or the level of domestic credit and the external sector or international reserves. The primary focus is on maintaining internal and external macroeconomic equilibrium. Internally, the disequilibrium is between government revenue and expenditure, whereas external imbalances refer to the disequilibrium between imports and exports on the one hand and capital movements on the other. And when an economy exhibits these imbalances, ameliorative measures must be taken. What is collectively termed stabilisation embraces the “corrective” measures such as fiscal, monetary and exchange rate policies (IMF, 1987).

This chapter reviews and evaluates the influence of the MABOP on IMF’s FP and the policy implications associated with it. The exposition starts with a general macroeconomic framework and sets out the FP framework starting with the Polak or the “Washington” model (Polak, 1957) as well as the Chicago models (IMF, 1977) and shows where FP is now, as set out in Khan and Montiel (1989) as well as Khan *et al.* (1990).<sup>1</sup> It is clear that the FP model is highly aggregated and gives pride of place to monetary variables as key determinants of the balance of payments. Proponents often argue that the model is eclectic. As will be shown, however, FP is essentially a short run monetary model with significant deflationary implications.

FP inspired stabilisation policies are not valid neither in terms of the analytical nor the historical literature (Taylor, 1997). The Washington consensus assumes that macroeconomic disequilibrium, particularly economic difficulties in developing countries is caused by internal or domestic policy errors. Thus, external disequilibrium is the result of internal policies that allowed aggregate demand to exceed aggregate output or income. This position is indefensible, as external causes such as decline in the terms of trade or changes in international monetary policy are often the causes of macroeconomic imbalances, leading to a fundamental methodological problem in the analysis of the crisis and its solution (Gore, 2000). The dissimilarity in the economic structure of developed and developing countries must also lead to prescription of different policies, which the Washington consensus often overlooks (Porter and Ranney, 1982). Application of standard IS/LM analysis to aggregate demand, where equilibrium between the flow of current output and stock of money is established, must also be different in developing countries. (Green, 1986).

Mainstream macroeconomic policy prescriptions, which the Washington consensus relies on, produce non-standard results when applied to LDCs. Monetary restriction and devaluation lead to both recession and inflation. The net impact of monetary contraction is a fall in output and an increase in the price level (Taylor, 1981, 1983 and 1988). These contrasts with the impact on developed economies where output falls and the price level also falls. This implies that the stabilisation and adjustment process is not necessarily smooth and has an element of stop and go (Mosley, 1991a). The usual stabilisation policies have very different, and in general less attractive, effects in developing countries than in developed economies. First, it is difficult to solve the balance of payments crisis and inflationary pressures, except through severe deflation to cut back import demand. Second, all macro policies have effects on the government budget and the balance of payments, which affect the monetary base. This in turn strictly limits ability to adjust economic conditions in more than the short run. Third, most restrictive policy is likely to worsen income distribution.

Although the rhetoric calls for reducing “unproductive” expenditures to restore fiscal balances (Tanzi, 1989a and 1994), reductions in public expenditure often fall on investment rather than consumption (Cornia *et al.*, 1987). Restraint on government



budgets mean reduction in much needed public investment in health, education, infrastructure and food subsidies. Fiscal austerity for macroeconomic balance does not take into account high return investments that compensate deficits in the long run through increases in tax revenues (see Alesina and Perotti, 1996 and Addison and Ndikumana, 2003). The demands of human development and cautionary prudence of financial conservatism are contradictory. Financial conservatism becomes less important when faced with key development questions in countries where economic and social deprivations are deep-rooted. The impact of social development through education and health, for instance, has been given less attention in modern economies when dealing with growth (Sen, 1998).

The FP framework, however, incorrectly sees the budget deficit as adding to demand at a higher level of employment and prescribes budgetary austerity to already impoverished countries (Dell, 1982 and Sachs, 2000). The Washington consensus is stuck with the idea that growth suffices to reduce poverty, regardless of the assumptions and where no targeted subsidies, credit and social safety nets exist (OAU, 1981; UNECA, 1989; and Mkandawire, 1998). No account is taken of the fact that credit expansion may be linked through policy with investment and capital accumulation (Tarp, 1993). Getting prices right is a cruel medicine and the short- to medium-term deflation certainly falls upon income.<sup>2</sup>

The rest of this Chapter is organised as follows. Section 2.2 discusses the case made for stabilisation and adjustment programmes on the part of the IMF and advocates of neo-liberal reforms. Section 2.3 outlines the general macroeconomic framework as a background for the FP model. Section 2.4 examines the monetary approach to the balance of payments, pinpointing its origins and additional influences. Section 2.5 extends the discussion of this approach and shows how the IMF built its financial programming model. Section 2.6 shows how FP is deflationary and inappropriate to address the development challenges faced by many developing countries. Concluding remarks are provided in Section 2.7

## 2.2 Why Stabilisation and Adjustment?

According to Williamson (2000, p. 252-253) the elements of the Washington consensus are:<sup>3</sup> a) fiscal discipline; b) redirection of public expenditure priorities towards health, education and infrastructure; c) tax reform, including the broadening of the tax base and cutting marginal tax rates; d) interest rate liberalisation; e) competitive exchange rate; f) trade liberalisation; g) liberalisation of inflows of foreign direct investment; h) privatisation; i) deregulation (to abolish barriers to entry and exit); and j) secure property rights. These policy measures are commonly divided into demand-side (stabilisation) and supply-side (adjustment) policies with the exchange rate having a supply as well as demand effect. Fiscal and monetary measures are categorised as demand-side policies while trade liberalisation, deregulation of markets, privatisation, and institutional reforms fall under supply-side policies. The thinking behind the IMF approach is to stabilise the economy in the short-run by demand side policies, while in the medium to long run adjusting or reforming the structure of the economy by supply-side policies.

The need for stabilisation arises due to the following: a country with a fixed exchange rate and a balance of payments equilibrium may be facing a rate of increase in its prices more than the increase in the foreign price level. This could be due to various reasons including wage inflation, excess monetary expansions, and a fiscal deficit. The consequence is to shift domestic demand towards imported goods while the world demand for exports of the country in question declines. This will result in pressures on balance of payments, particularly the current account balance, which could be financed by borrowing from abroad or running down international reserves. As is also apparent from discussion in the next chapter, orthodox adjustment policies base their argument for reform on government failure. These involved regulation of prices, which led to loss of international competitiveness; exchange controls, which led to illegal transactions; import-substitution policies, which focused on encouraging domestic manufacturing capability through import controls; overvalued exchange rates; binding ceilings on interest rates; and a heavy dose of public ownership. The

argument is that these policies required state administration and intervention, which turned out to be an avenue for self-interest.

Thus, given the above case for stabilisation, there are two policy options. First, most developing countries pursued a strategy of exchange control and quantitative restrictions to suppress the demand for imports and at the same time lessen the pressure on reserves. This, according to proponents of IMF stabilisation programs, resulted in inefficient rent-seeking; over-invoicing and under-invoicing of imports and exports respectively; smuggling; exaggerated tourist expenses; overpayments for overseas obligations; and errors and omissions in trade statistics. Quantitative restrictions also, resulted in severe shortages of vital inputs such as petroleum, machinery and fertilizers (see Krueger, 2000). The second option, which is favoured by advocates of the IMF stabilisation approach, is the deflationary option: Using monetary, fiscal and exchange rate policies the demand for imports can be restrained and the pressure on reserves relieved. Earlier studies of IMF stabilisation programmes outline the conceptual framework and show how demand-side policies can be used to restore equilibrium between aggregate demand and aggregate supply (Crockett, 1981, Khan and Knight 1981, 1985 and 1987, and IMF, 1987).

The central premise of the deflationary option states that the rate of growth of aggregate demand needs to be consistent with the rate of growth of aggregate real supply *plus* net capital flows from abroad. If the economy runs a rate of growth of demand in excess of the rate of growth of real supply of output, the price level and the deficit in the balance of payments increase. Hence, equilibrium is restored via FP, which restrains aggregate demand. It is essential to note that IMF programmes are designed under the assumption that the "crisis" in stabilising and adjusting countries is internal or domestic in nature. The line of reasoning follows that; first, external disequilibrium is the result of internal policies that allowed aggregate demand (absorption) to exceed aggregate output or income. Second, government-induced distortions resulted in inefficient allocation of resources. It means external causes such as decline in the terms of trade, the debt overhang and trade barriers are ignored. The emphasis on internal factors rests on the argument that the existence of external factors does not mean there is no need for domestic adjustment. External economic

factors are part of the benign and malign of global economics. As key IMF officials argued during the heydays of stabilisation, the emphasis on internal factors is because that is what a country can influence and for what it can obtain financial assistance (Quattara, 1986).

## 2.3 The General Macroeconomic Framework

Financial programming models often make reference to a small open economy under a fixed nominal exchange rate regime. The analysis starts with a macroeconomic framework, in which the economy is divided into four sectors. Namely the private sector, the public or government sector, the foreign sector, and the monetary sector. The macroeconomic assumption is that for any sector, income generated from production plus net transfers must equal expenditure plus savings of the sector in question. It is also assumed that savings are channelled to borrowing and the two together equal physical and financial asset acquisition.<sup>4</sup> As shown below, FP models take the Keynesian general macroeconomic framework of national income; savings and investment; public sector deficit; and balance of payments deficit as their starting point. The venture is adding financial models to explain changes in the balance of payments.

### 2.3.1 The Private Sector

The private sector consists of households and firms. Its income ( $Y_p$ ) is generated from workers' wages ( $\omega$ ); capitalists' profit ( $\pi$ ); net transfer from the government ( $TR_{gp}$ ) in the form of welfare and other benefits; and net transfer from the foreign sector ( $TR_{fp}$ ). The private sector's expenditure ( $E_p$ ), on the other hand, is composed of consumption ( $C_p$ ), taxes ( $T_d$ ), interest payment on foreign debt ( $IP_{pf}$ ) and savings ( $S_p$ ). Therefore, income and expenditure for the private sector can be stated as follows:

$$Y_p = \omega + \pi + TR_{gp} + TR_{fp}$$

$$E_p = C_p + T_d + IP_{pf} + S_p$$

Private sector savings *plus* domestic credit ( $dDC_p$ ) *plus* borrowing from the foreign sector ( $dB_{fp}$ ) or net private sector assets are held in the form of private investment ( $dK_p$ ), money ( $dM$ ), net private borrowing to the government ( $dB_{pg}$ ) and net foreign assets ( $dFA_p$ ). Where  $d$  is the first difference operator, which denotes a one period change (e.g.  $dDC = DC_1 - DC_0$ ), the following identity can be formulated:

$$S_p + dDC_p + dB_{fp} = dK_p + dM + dB_{pg} + dFA_p$$

The budget constraint of the private sector expressed in terms of the resource gap ( $S_p - dK_p$ ) is, therefore, equal to:

2.1

$$\begin{aligned} S_p - dK_p &= Y_p - C_p - T_d - IP_{pf} - dK_p \\ &= dM + dB_{pg} + dFA_p - dDC_p - dB_{fp} \end{aligned}$$

### 2.3.2 The Government Sector

The government revenue or income comes from direct and indirect taxes ( $T$ ); revenue from state-owned enterprises such as utilities ( $SE_g$ ); and transfer from the foreign sector ( $TR_{fg}$ ), in the form of aid, for instance. Government expenditure ( $E_g$ ) is on consumption ( $C_g$ ); net transfer to the private sector ( $TR_{gp}$ ) as described above; interest payment on loan from the foreign sector ( $IP_{gf}$ ) and savings ( $S_g$ ). Income and expenditure for the government sector can be expressed as follows:

$$Y_g = T + SE_g + TR_{fg}$$

$$E_g = C_g + TR_{gp} + IP_{gf} + S_g$$

Government savings plus borrowing from the private and foreign sectors or net public assets are held in the form of public investment and net foreign assets. The

government obtains credit from the domestic monetary system and loans from the private sector.

$$S_g + dDC_g + dB_{pg} + dB_{fg} = dK_g + dFA_g$$

The budget constraint of the government sector is expressed in terms of the fiscal deficit ( $S_g - dK_g$ );

2.2

$$\begin{aligned} S_g - dK_g &= Y_g - C_g - TR_{gp} - IP_{gf} - dK_g \\ &= dFA_g - dDC_g - dB_{pg} - dB_{fg} \end{aligned}$$

### 2.3.3 The Foreign Sector

The foreign sector gets income ( $Y_f$ ) from its exports or imports of the domestic economy ( $Z$ ), interest payments from the private ( $IP_{pf}$ ) and government sectors ( $IP_{gf}$ ). Expenditure ( $E_f$ ) by the foreign sector is on exports ( $X$ ) from the domestic economy or its imports, net transfers to the private ( $TR_{fp}$ ) and government ( $TR_{fg}$ ) sectors, respectively, and foreign savings ( $S_f$ ). The foreign sector's income and expenditure can also be expressed as follows.

$$Y_f = Z + IP_{pf} + IP_{gf}$$

$$E_f = X + TR_{fp} + TR_{fg} + S_f$$

Where  $e_t$  denotes the exchange rate and  $R$  the level of international reserves, foreign savings or net accumulation of assets by foreign residents against the domestic economy is equivalent to the liabilities of the same economy.

$$S_f = - (dFA_p + dFA_g + e_t dR)$$

Since the current account is defined as exports of goods and services less imports of goods and services including interest payments and net transfers, the foreign sector's budget constraint can be expressed as:

2.3

$$CA = X - Z - IP_{fp} - IP_{gf} + TR_{fp} + TR_{fg}$$

or

$$CA = dFA_p + dFA_g + e_t dR$$

#### 2.3.4 The Monetary Sector

As the domestic monetary sector does not generate income, expenditures cannot be identified nor a budget constraint specified. The role of the monetary sector is intermediary. Its primary function is to disburse domestic credit to the private and government sectors ( $DC = DC_p + DC_g$ ) and deposit international reserves ( $e_t R$ ). Hence the monetary system can be expressed in terms of a balance sheet identity with credit and reserves as assets and money ( $M$ ) as liability. Equation 2.4 is the foundation for MABOP or financial programming and shows the relationship between the domestic economy and the balance of payments.

2.4

$$dM = dDC + e_t dR$$

#### 2.3.5 National Income and Absorption

Summing equations 2.1 to 2.3 and subsuming interest payments and other transfers into exports and imports—for simplicity—and where  $G$  is government expenditure the overall balance equation or the national income identity is given by:

2.5

$$Y = C + dK + G + X - Z$$

Equation 2.5 can also be written as:

2.6

$$C + dK + G = Y + Z - X$$

Equation 2.6 tells us that the amount of absorption ( $C + dK + G = A$ ) of goods and services in the economy is financed by income from domestic production ( $Y$ ) or from the external sector ( $Z - X$ ). Another way of looking at equation 2.5 is in terms of the trade or current account balance. Where the consumption function is Keynesian ( $C = a + bY$ ), the change in the trade balance, is given by;

2.7

$$X - Z = Y - (C + dK + G)$$

$$X - Z = Y - A$$

$$CA = Y - A$$

$$dCA = (1-b)dY - dA$$

The absorption approach is a simple stabilisation model, in which the behavioural content is broad and country specific. It does not show a cause and effect mechanism. For instance, if imports exceed exports or the current account balance is negative, the economy is absorbing more from the external sector than domestic production. The analysis focuses on the view that depreciation of the exchange rate leads to expenditure-reduction on domestic output. Put differently, the higher the average propensity to import and the lower the price elasticity of demand for imports, the deflationary impact of devaluation is considerable. On the other hand, if export supply responds to the devaluation positively, the deflationary impact may be offset or is small as a result of increased demand for domestic output, generated in the export sector.

The choice between the two deflationary options, that is domestic credit restraint and devaluation, depends on a number of factors. For instance, where industry relies on credit finance, monetary control is not preferred, at least in high



magnitudes. Second, if the economy exhibits large unemployment and low output, exchange rate depreciation is preferred anticipating that it will bring about relative price changes and increase in demand for exports and import substitutes or expenditure-switching (see the next Chapter for extended discussion of exchange rate policy for expenditure-switching). Third, it is technically easier to devalue the currency with just one public announcement. Finally, devaluation is favoured for its effect on changing expectations as well as for its uniform impact cross sectors (Bird, 1983).

In the case of expenditure-reduction, devaluation must either increase income (Y) or decrease absorption (A) to improve the current account balance (CA). These are the demand- and supply-side effects of exchange rate policies. The effect on income could be through increased demand for and supply of exports as well as a rise in the demand for import substitutes as well as the terms of trade effect. On the other hand, the impact on absorption is firstly through the Pigou effect where an increase in prices of imports leads to a fall in wealth and consumption.<sup>5</sup> Secondly, depending on the response of money wages to the increase/decrease of profitability in the tradable and non-tradable sectors as well as factor intensities and factor mobility in the tradable sector, devaluation could result in a redistribution of income from wages to profit. This is under the assumption that a higher proportion of savings are made out of profit than wages. Wage earners and profit earners differ in their marginal propensities to spend, redistributing income from labour to capital (Krugman and Taylor, 1978). If the supply of exports increases due to devaluation, the deflationary impact may be offset if the government raises revenue and hence expenditure by taxing new profits. However, it has been found that, at least in the short run, devaluation has a redistributive effect as well as changes the domestic terms of trade (Krueger, 1978 and Bautista, 1982). Expenditure is also affected as devaluation increases the domestic currency cost of debt-servicing significantly (Bird, 1983).

### 2.3.6 Savings and Investment

The relationship between savings, investment and the balance of payments can also be analysed from the above equations.<sup>6</sup>

2.8

$$\begin{aligned}
 X - Z &= (Y - C) - dK - G \\
 X - Z &= S - dK - G \\
 dK + G &= S - (X - Z) \\
 dK_p + dK_g + G &= S_p + S_g - (X - Z)
 \end{aligned}$$

Equation 2.8 shows that if savings from the private as well as the government sectors fall short of the levels needed to finance investment and autonomous government expenditure, resources must come from the negative external resource balance. The link between savings and the balance of payments can clearly be seen from the following relationship. By adding equation 2.1 and 2.2 and using the balance of payments identity we obtain:<sup>7</sup>

2.9

$$\begin{aligned}
 (S_p - dK_p) + (S_g - dK_g) &= dM + dFA - dDC \\
 (S_p - dK_p) + (S_g - dK_g) &= dFA + e_t dR
 \end{aligned}$$

The implication of this analysis is that if an improvement in the current accounts is sought, private or government savings must rise relative to investment. An increase in aggregate savings, therefore, is crucial to improve the balance of payments as well as promote long-term growth through financing fixed capital formation. This is one of the aspects that gave rise to the MABOP. Raising aggregate savings relative to investment requires a monetised economy and a well functioning financial sector, which is lacking in most developing countries. Hence, the policy option focused on manageable monetary variables such as the level of domestic credit.

### 2.3.7 Public Sector Deficit

As shown in equation 2.2 the government fiscal deficit can only be financed by borrowing from the foreign and private sectors as well as credit from the domestic

monetary system. The change in net foreign assets takes place through foreign borrowing by the government or decreasing reserves through  $e_t dR$  (equation 2.4).

2.10

$$S_g + dK_g = dFA_g - dB_{pg} - dB_{fg} - dDC_g$$

Equation 2.10 can be rewritten as the government budget deficit to show the mechanisms through which a deficit can be financed.

2.11

$$S_g - dK_g = dK_p - S_p + dFA + (dM - dDC)$$

Equation 2.11 states that the government fiscal deficit is also financed when private savings exceeds private investment or by an increase in foreign indebtedness (i.e. a decrease in net foreign assets) or an increase in domestic credits which are in excess of the demand for money. This last method may imply monetisation of the deficit. The relationship between the fiscal deficit and the balance of payments is borne out when the deficit is financed through running down international reserves. Unless there is a counter movement in the current account through for example, an increase in exports or demand for import substitutes, the balance of payments will deteriorate due to the method of deficit financing. Capital flight also has a direct effect on the balance of payments, which implies a reduction in net private borrowing to the government and an increase in net foreign asset of the private sector (Equation 2.10). This process has implications for the public sector borrowing requirement and consequently to the balance of payments if the deficit is monetised. Once again reduction of government deficit, via imposing ceilings on the level of domestic credit expansion, becomes an easy policy option where an increase in exports and the demand for import substitutes is not feasible in the short run.

### 2.3.8 Balance of Payments Deficit

Equation 2.3 can also be written in terms of resource balance as follows:

2.12

$$X - Z = (IP - TR) + dFA + e_t dR$$

The above equation states that if interest payments (IP) by the private as well as the government sector are too high, a negative resource balance is only possible if net transfers (TR) exceed interest payments or international reserves can be utilised. Net transfers can exceed interest payments if additional foreign borrowing or aid is available. Manipulating equations 2.3 and 2.4 shows the link between the domestic monetary system and the balance of payments:<sup>8</sup>

2.13

$$CA = X - Z - IP + TR = dFA + e_t dR$$

$$dFA + e_t dR = Y - A - IP + TR$$

$$e_t dR = (Y + TR - dFA - IP) - A = dM - dDC$$

Equation 2.13 implies that the amount of domestic absorption A exceeds income plus net transfers by the same amount by which domestic credit exceeds the domestic demand for money. The central conclusion of this analysis is that the imbalance between aggregate supply (domestic production) and aggregate demand (absorption) and the resulting inflationary pressure is the result of liberal credit expansion, hence a deterioration in the balance of payments or a fall in international reserves. This gave rise to the MABOP.

## 2.4 The Monetary Approach to the Balance of Payments (MABOP)

Models that link the balance of payments with financial variables have developed within the IMF's Research Department and are mainly associated with the monetary theory commonly known as the Mundell-Fleming model. The essence of the model is set out in Polak (1957) and Polak and Argy (1971).<sup>9</sup> Later in the 1970s, under the title *The Monetary Approach to the Balance of Payments*, the models were

further popularised by Chicago researchers in Frenkel and Johnson (1976), Johnson (1977) and IMF (1977). Polak (2001) argues that the “Washington” or the Polak model and the Chicago model differ in their inspiration and in the way they treat the time horizon for the adjustment mechanism or the multiplier effect of expansion in domestic credit. The Polak model stemmed from an attempt to explain income and the balance of payments with monetary factors under the assumption of “a regime of par value”. On the other hand, the Chicago model was formulated to investigate the impact of exchange rate changes, mainly devaluation, on the balance of trade based on the absorption approach. Both models, however, link the balance of payments with monetary variables where policy allows the latter to influence the former.

### 2.4.1 The Polak Model

The approach to the balance of payments associated with Polak (1957) differs from the conventional thinking (i.e. the elasticities and absorption approaches) because of its emphasis on the effect of domestic credit on the balance of payments and the role of the government deficit as the generator of domestic credit. Polak argued;

“the multiplier analysis was a simplification that seemed particularly appropriate in the depression conditions of the 1930s when the demand for money was highly elastic. This particular simplification is much less useful in dealing with developing countries, where money is kept almost exclusively for transaction purposes and its demand is not very elastic” (Polak 1957, p. 2).

Polak also argued that when the demand for money is elastic, policy makers cannot afford to ignore monetary variables and rely exclusively on the multiplier. A key element in the emergence of MABOP is its rejection of the Keynesian assumption that changes in the level of domestic credit can have an impact on net foreign lending via changes in the interest rate. The fundamental concept behind MABOP is that when monetary expansion from domestic sources exceeds the demand for money, further spending, particularly on imported goods and services will cause deterioration in the balance of payments via the money supply and international reserves. According to

Polak (2001) domestic credit is a combination of business investment that is not self-financed or not financed by sales of shares and bonds; consumer spending financed by credit from the banking sector; and most importantly government deficit spending financed by the domestic financial system.

Given the above background, equations 2.3, 2.4, 2.5 and 2.10, namely the national balance, the external balance, the monetary balance and the fiscal balance provide the framework to the Polak model. However, these equations are referred to as the “empty framework”, mainly because they are macroeconomic identities and do not show a transmission mechanism due to the absence of behavioural equations. As Tarp (1993, p.60) notes, these “identities do not give clues how *ex ante* gaps (i.e. differences among the “intentions” or “plans” of the various sectors at the beginning of a period under study) must close during the period so that they are in balance *ex post*.” The contribution of Polak, therefore, is to include the two behavioural equations (the demand for money and the demand for imports) in the general macroeconomic framework outlined above. In doing so Polak identified a mechanism through which policy makers can affect the balance of payments.

The principles involved in the Polak model are relatively simple. First, there is a stable relationship between the supply of money and the level of nominal income determined by expenditure – extra income leads to extra spending. Second, expenditure can either be made on domestically produced goods or on imports. Third, if imports exceed exports, then there will be a balance of trade deficit, which will have to be covered by an outflow of foreign reserves at the expense of the domestic money supply (and inflow for balance of trade surplus). Fourth, with a new level of money supply established, the whole process is continuously repeated. One immediate implication is that increases in the domestic supply of credit will lead to an increase in imports and a corresponding outflow of foreign reserves restoring the overall money supply to its initial level (Fine and Hailu, 2001),.

As a monetarist approach the model assumes that all markets can work perfectly.<sup>10</sup> Other implicit assumptions include no capital mobility, savings equate investment at all times and endogeneity of the money supply. The characteristic of the

country in which the Polak model operates is a small open economy with a fixed nominal exchange rate. Using the balance sheet approach, as was illustrated in Equation 2.4 above, Polak explains the changes in the money stock (M) as the change in the assets items—foreign assets of the banking system ( $e_t R$ ) and domestic assets of the banking system (DC).<sup>11</sup> Therefore,

2.14

$$dM_t^s = e_t dR + dDC$$

By treating net transfers (TR) *less* interest payments (IP) *less* the change in net foreign assets ( $dFA$ ) as “non-trade related foreign currency inflows”<sup>12</sup>  $dF$  for simplicity, equation 2.12 can be expressed as:

2.15

$$\begin{aligned} e_t dR &= X - Z - IP + TR - dF \\ e_t dR &= X - Z + dF \end{aligned}$$

Thus the change in the stock of money can be expressed as follows;

2.16

$$dM = X - Z + dF + dDC$$

In addition to the assumption of supply-side determined output, the key assumption of the Polak model is constant velocity of circulation of money ( $v$ ), which is the frequency with which money changes hand is constant, which forms a proportional relationship between the change in the money stock and income. In other words, the velocity of circulation is institutionally determined at least in the short-term. Thus;

2.17

$$dM = Y_t - Y_{t-1} = dY$$

Equation 2.16 combined with equation 2.15 gives the formal equation for the determination of income.

2.18

$$Y_t = Y_{t-1} + dDC + X - Z + dF$$

Besides domestic credit the other variable that determines income and the balance of payments, identified by Polak, is the level of exports. Since exports are treated as exogenous—determined by foreign demand—most of the variation in the balance of payments occurs through changes in imports. It follows that, if the increase in domestic credit is used entirely for expenditure on locally produced goods, income increases in the same proportion. At the other extreme, if the increase in domestic credit is used for expenditure on imports, the effect on income will be insignificant.

This leads to the introduction of the two behavioural relationships in the model – the demand for money and import functions. The demand for money function in this model is restricted in a sense that it excludes the effect of expected inflation and the rate of interest. It also relies on nominal income as the main determinant of money demand. The justification for the exclusion of the rate of interest is on the basis that in most developing countries the capital market, which enables the transition between money and real assets, is underdeveloped. Therefore, changes in the rate of interest do not stimulate changes between money and real assets, effectively ruling out the effect of fiscal and monetary policy on the balance of payments as set out in the Mundell-Fleming model. The demand for nominal money balances  $M_t^d$ , where  $v$  is a constant income velocity of money, is stated as follows:

2.19

$$M_t^d v = Y_t$$

$$dM_t^d = v^{-1} dY_t$$



The demand for money equation is derived from quantity theory—under the treatment of output as an exogenously determined variable. In the above model, “flow” equilibrium in the money market is assumed to hold, that is the public “will succeed in adding to its balances at the desired rate during the programmes period” (Khan *et al.*, 1990, p. 159). Therefore the demand for money is at constant equilibrium with the supply of money ( $dM_t^d = dM_t^s = dM_t$ ). Agénor and Montiel (1996) formalise this as;

2.20

$$M_t^d = v_t^{-1} y_t - v_{t-1}^{-1} y_{t-1}$$

The treatment of imports in this model is such that imports are specified as a fraction of nominal income where  $\mu$  is marginal change in the value of imports due to a change in nominal income. In Polak (1957), the current level of demand for imports is dependent on the previous level of nominal income.<sup>13</sup> The import function in the Polak model is similar to that of the Keynesian multiplier although the effects of consumption, investment and savings are excluded (savings are taken to be immediately invested,  $S=I$  at all times).

2.21

$$Z_t = \mu Y_t$$

The Polak model is a simultaneous model consisting of the above four equations namely the balance sheet identity (equation 2.14), the external balance (equation 2.15), demand for money (equation 2.19) and imports (equation 2.21). The reduced form of these equations can be written as:<sup>14</sup>

2.22

$$e_t dR = X - \mu(Y_t - dM_t^d v) + dF$$

Equation 2.22 shows how the transmission mechanism from domestic credit to the balance of payments takes place. An increase in domestic credit increases the

money supply through equation 2.14. Since the money market is in equilibrium the increase in the money supply implies a proportional increase in the demand for money. This, through equation 2.19, leads to a rise in income. Similarly, as indicated by equation 2.21 the demand for imports will rise. Finally, this will cause a fall in international reserves until it restores the money supply at its previous level via equation 2.14. The transmission mechanism of any change in the exogenous variables can be shown to be that, in the short-run, income will change by a multiplier.

Forty years after his original model was specified, Polak (1997), states;

“One Key characteristic of the model is its simplicity. There were two good reasons for this. First, at the analytical level, simplicity was inevitable in our view of the paucity of basic economic data such as national income in the early post-war years for many of the Fund’s member countries, the total absence of econometric models to describe their economies, and indeed the probability that this situation would not be remedied for decades ahead. Hence the choice of the model that needed as inputs only two sets of statistics that were generally available—like banking data and trade data. Second, and even more important, simplicity kept the model focused on the key variable that governments could control—domestic credit creation—that was seen as crucial to the correction of the balance of payments problems for which IMF assistance had been invoked” (p.16)...“The standard IMF conditionality thus evolved the inclusion of a double monetary prescription: setting a ceiling on the expansion of the domestic assets of the central bank to achieve an acceptable balance of payments result (a flow concept) and a floor under the central bank’s holdings of net foreign assets (a stock concept) to bring about a satisfactory level of foreign reserves, and to ensure that the central bank would not use excessive intervention to counter market pressures for a more depreciated exchange rate” (p.17-18).

Polak also stated that the model has both Keynesian and monetarist elements. The former is borne out as a multiplier model with a marginal propensity to spend and the latter via the assumption of constant velocity of money circulation. Polak also notes that the model has changed and embraced new variables. For instance, domestic credit was divided into “credit to the private sector (usually to be encouraged) and credit to the government sector (usually to be discouraged)” (p.17). Moreover, a typical financial programming model distinguishes between harmful and necessary taxes, judgements on defence expenditure, debt, and concern with human capital, social safety nets and poverty.

### 2.4.2 The Polak Model and Real Variables

The original Polak model was expressed in nominal terms implying no distinction between a change in prices and a change in real income. The following equations include prices and thus real variables to define the model in real terms. The inclusion of real variables shows the transmission mechanism clearly. For instance, depreciation of the exchange rate raises the domestic price level. This in turn increases the demand for nominal money balances. As the money supply is affected through reduction in domestic credit and changes in international reserves, stock equilibrium in the monetary sector is achieved.

The inclusion of real variables is shown as follows. Income now is expressed as:

2.23

$$Y_t = P_t \tilde{y}_t$$

$$dY = dP y_{t-1} + P_{t-1} \tilde{y}_t$$

When price is included in the demand for money function, it becomes identical with the equation for the quantity theory of money .

2.24

$$M_t^d v = P_t \tilde{y}_t$$

When equation 2.24 is expressed in terms of first difference it becomes:

2.25

$$dM^d = v^{-1} d(P_t \tilde{y}_t)$$

$$dM^d = v^{-1} (dP d \tilde{y} + P_{t-1} d \tilde{y} + dP y_{t-1})$$

$$dM^d = v^{-1} (dP \tilde{y}_t + P_{t-1} d \tilde{y})$$

Given  $Y_t = Y_{t-1} + dY$  the import function becomes:

2.26

$$\begin{aligned}
 Z_t &= \mu (P_t y_t) \\
 dZ_t &= \mu (dP \dot{y}_t + P_{t-1} d\dot{y}) \\
 dZ_t &= \mu [P_{t-1}(\dot{y} + y_{t-1})] + \mu \dot{y}_t dP
 \end{aligned}$$

Using equation 2.14, and 2.25, international reserves can be expressed in terms of real variables as follows:<sup>15</sup>

2.27

$$e_t dR = v^{-1} dP \dot{y}_t + v^{-1} P_{t-1} d\dot{y} - (dDC_p + dDC_g)$$

Setting desired values for the price level, real output and international reserves, the model is used to solve for credit expansion. If prices and output are determined outside of the system, then there is a one-to-one relationship between changes in domestic credit and international reserves: the same result as the model in nominal terms.

Similarly, using equation 2.15 ( $e_t dR = X_t - Z_t + dF$ ) and substituting 2.26 for  $Z_t$  we obtain:

2.28

$$e_t dR = (X_t + dF) - \mu (P_{t-1} d\dot{y} + y_{t-1}) + \mu \dot{y}_t dP$$

Equation 2.28 is the same as writing the Polak model expressed in nominal income (equation 2.21) in terms of real variables, that is international reserves as a function of prices and real income.

Using the above equations and the equilibrium condition in which the demand for money and the supply of money are equal ( $M_t^d = M_t^s$ ) the model serves to investigate the effects of changes in the exogenous variables (domestic credit and exports) on the endogenous variables (imports and income). For instance, an increase

in the level of domestic credit will result in an increase in the money supply. Such an increase in the money supply will raise income and expenditure. The dynamics of the transmission mechanism works under the assumption that the government takes no action to sterilise the effect on the money supply. In this model the restriction is as follows: domestic credit expansion is only permitted when it is equivalent to the difference between the demand for money that is triggered by growing nominal income and the amount provided by reserve accumulation. If there is a lasting increase in domestic credit, the short-term effect is a rise in income followed by an increase in the money supply and consequently a rise in imports. In this process, however, international reserves continue to fall, as there is no matching increase in exports.

The decline in international reserves, therefore, is equal to the extra domestic credit injection. In the long-term this leaves nominal income and imports unchanged from their original level. This conclusion confirms the link between the domestic monetary system and the external sector.

Polak asserts the implication of the transmission mechanism in which a lasting increase in domestic credit leads to a rise in imports and a fall in international reserves as follows:

“The economic development could have been financed by higher taxes or foreign loan. The factories might have been built by restriction of consumption or by the repatriation of capital. In all these situations, the desire to spend for a particular purpose would not have led to a payments problem. In a real sense, the credit expansion is the cause of payments problem” (Polak, 1957, p. 13).

The policy conclusion from the above argument is as follows: in order to achieve a set target for the balance of payments, particularly the current account, domestic credit must be restrained. Particular emphasis is placed on credit to the government. It is often assumed that much of the domestic credit is absorbed by the public sector. Equation 2.10 shows that if public expenditure is in excess of public savings it must be financed by credit creation—assuming foreign assets are predetermined and limited public borrowing from the private and the public sector

$$(dK_g - S_g = dB_{pg} + dB_{fg} + dDC_g - dFA_g)$$

On the other hand, if there is a lasting increase in exports income is assumed to increase by the same proportion. Since the demand for money is a function of income, given the velocity of circulation, the quantity of money also increases. If the excess money supply is spent on domestic goods and services, money or nominal income increases. However, the changes in prices and income depend on whether there is excess capacity in the economy or not. If the economy has excess capacity there may be little or no increase in prices and real income could rise. If the economy is operating under full capacity, on the other hand, domestic prices rise relative to world prices and real income falls or demand shifts to imports – with little or no improvement in international reserves. The Polak model can also be used to analyse the effect of exogenous increase in the level of imports (or a fall in exports) - an increase in imports reduces income, with a corresponding fall in reserves and the money supply.

### 2.4.3 The Chicago Model

The theory of the monetary approach to the balance of payments is closely associated with papers contained in Frenkel and Johnson (1976) and is commonly referred to as the Chicago model. This model is similar to Polak's version as it assumes the balance of payments to be entirely a monetary phenomenon. The policy implications of the two models are similar. According to the Chicago version of the model, the link between the domestic component of the money stock (domestic credit) and international reserves allows domestic credit to be a policy variable that can be set at a desired level of the balance of payments. Both the Polak and the Chicago models assume perfect substitution between goods, wage and price flexibility and the country is taken as a price taker—who sets prices, however, is one of the most contentious issues. The difference between the two models lies on the assumption of full employment (which rejects the Keynesian flavour unlike the Polak model) and the law of one price by the Chicago model. Polak (2001, p. 12) states that in the Chicago model “money is not brought in as a contributing factor in the explanation of the balance of payments. It enters at the very beginning of the story, as a kind of anti-

Keynesian manifesto". Another departure of the Chicago model from the Keynesian tradition is also the claim that the authorities cannot sterilise the effect of disequilibrium in the balance of payments in the short-run. Hence, using the money supply as a short-run policy variable provides the perfect solution. Key to the Chicago model is also the assumption that autonomous domestic demand or the excess domestic credit has no effect on the demand for money. This is because, in the long run, instantaneously clearing markets will restore equilibrium back to the original starting point.

Thus, the Chicago approach separates nominal income from real income through the inclusion of the domestic price level  $P_d$  as a product of the exchange rate ( $e$ ) and the foreign price level  $P_f$  in line with Purchasing Power Parity (PPP) theory. Thus,

2.29

$$P_d = eP_f$$

Real income in this model is exogenously determined by the neo-classical aggregate supply function and, contrary to the Keynesian approach, does not rely on aggregate demand. Its growth over time, drawing on Solow's (1956) vintage model, is dependent on some residual, such as technical progress. The demand for money function in this model is similar to the original Polak model except that the demand for money is now dependent on real income rather than nominal income. The velocity of circulation is set equal to one and the equilibrium condition in the money market holds. Therefore;

2.30

$$M_{dt}^d = P_{dt} f(\tilde{y}_t)$$

2.31

$$e_t R = P_{dt} f(\tilde{y}_t) - DC$$

To determine the rate of change in international reserves, equation 2.31 is differentiated with respect to time ( $t$ ).<sup>16</sup> If the foreign price level, the exchange rate and real output are assumed to be constant, the change in reserves is given by;

2.32

$$dR/dt = - dDC/dt$$

Equation 2.32 implies the rate of change of international reserves is equal to the rate of change of domestic credit. Although the Chicago model assumes the economy to be at full employment, the expansion in domestic credit does not lead to an increase in prices. This is because of the assumption of the law of one price. If the domestic price level rises, demand would shift to foreign goods, as the world price, under a fixed exchange rate, is now lower than the domestic price level. The transmission mechanism in the Chicago model is quick adjusting, that is the fall in international reserves is matched by a decline in the supply of money so that the balance sheet identity holds. This implies any excess supply of money is eliminated instantaneously. This process is clearly demonstrated in equation 2.33 in which the world price level, real income and the exchange rate determine the supply of money exogenously.

2.33

$$M_t^S = eP_f f(\bar{y}_t)$$

Differences between the Polak and Chicago models also include, for the latter model, the absence of an import function, the assumption of full employment and capacity output at all times. This implies that any disequilibrium in the money market leads to changes in the price level or changes in international reserves without changes in income as the Polak model suggests. Nevertheless, the policy conclusion of the Chicago model is consistent with the conclusion of the Polak model, namely balance of payment targets can only be achieved through restriction of domestic credit in line with the level of demand and thus with the level of growth of output. Any movement below or above this equilibrium will result in movements in the opposite direction than necessary to restore the monetary balance. If the rate of expansion in domestic



credit exceeds the demand for money, international reserves will fall and consequently the balance of payments will deteriorate.

## 2.5 A Complete Model for IMF Financial Programming

It is surprising to note that there are only limited writers who present the complete model of IMF's financial programming. The IMF itself has also raised this point:

"based largely on oral tradition. There is surprisingly little readily accessible written material on its theoretical underpinnings, in particular, on the interaction among policy measures in achieving the ultimate objectives ... Since the early 1970s, however, the conception and the structure of adjustment programmes have gradually evolved and expanded" (IMF, 1987, p. 1).

The complete model of financial programming is a quantitative modelling framework used by the IMF for determining policy targets, which in turn have to be consistent with a set of macroeconomic objectives. Hence, it is a consistency framework that attempts to ensure that the balance of payments position is sustainable, that growth and inflation objectives are consistent with monetary targets and that the budgetary expenditures are also consistent with projected financing. The stated objectives of the IMF in its financial programming exercise are to bring about sustainable balance of payments position and control inflation. These objectives—to be consistent with the Meade-Tinbergen-Mundell principle – however, cannot be achieved with one instrument: the domestic credit.

The Meade-Tinbergen-Mundell principle focuses on the need for a one-to-one concordance of policy instruments and targets. The principle was born out of the post World War II analyses of policy making in an open economy. The problem tackled by Meade (1951), Tinbergen (1952) and Mundell (1960) was to devise a method for working out combinations of policy instruments to achieve desired changes in target variables. The basic tenet of the principle focused on building a model of an economy whereby a number of instrument variables could be consistent with an equal number of policy targets. If the equations in the model are consistent and independent, one

could specify desired values for target variables by solving the model with an equal number of instruments. The principle was based on three ideas: 1) assigning each instrument where it is most effective to affect the target variable; and 2) distinguishing between fixed and flexible exchange rates when assigning instruments to targets. Under a fixed exchange rate system it was argued that fiscal policy was most effective to correct internal imbalances, while monetary policy was effective to correct the deficit in the external sector (see Friedman, 1988 and Niehans, 1968).

Khan *et al.* (1990, p. 162), in providing a complete FP framework, point out that “[T]he use of the exchange rate as a policy tool provides a way out of this [target-instrument] dilemma.” Hence, the MABOP (Polak and Chicago) models can be specified by introducing the price equation;

2.34

$$dP_t = (1-\theta) dP_d + \theta deP_f$$

Where  $\theta$  is “the share of importable goods in the overall price index”, equation 2.34 adds a new policy instrument [ $de$ ] (*ibid.*, p. 162). Substituting equation 2.34 into equation 2.30 and setting  $dP_t d\dot{y}_t = 0$  or ignoring second-order terms yields:

2.35

$$dM_t^d = v^{-1} \dot{y}_t (1-\theta) dP_d + v^{-1} \dot{y}_t \theta deP_f + v^{-1} P_{t-1} \dot{y}_t$$

Khan *et al.* (1990) introduced the concept of valuation change in variables affected by changes in the exchange rate. Valuation change is defined as a change in, for instance, the foreign currency value of the stock of international reserves, the stock of imports and exports at the previous period multiplied by the change in the exchange rate. These would be  $R_{ft-1} deP_f$ ,  $Z_{t-1} deP_f$  and  $X_{t-1} deP_f$  respectively. Thus, the money supply identity can be written as:

2.36

$$dM^s = e_t dR + R_{ft-1} de + dDC$$

Substituting the demand for money (equation 2.35) and the supply of money (equation 2.36) functions into the equilibrium condition ( $M_t^d = M_t^s$ ) and solving for  $e_t dR$  yields:

2.37

$$e_t dR = v^{-1} P_{t-1} d\ddot{y} + [v^{-1} \ddot{y}_t P_f \theta - R_{ft-1}] de - dDC + v^{-1} \ddot{y}_t (1 - \theta) dP_d$$

Khan *et al.* also change the more restricted import function as specified by equation 2.26 by expressing the import volume equation ( $Z_q$ ) as a function of income and relative price of foreign goods in terms of domestic goods. Thus;

2.38

$$Z_q = \eta_0 + \eta_1 \ddot{y} - \eta_2 eP_f/P_d$$

Given  $Z_t = dZ + Z_{t-1}$  and assuming  $dZ$  is composed of changes in import volume due to a additional payment for imports and a valuation change due to exchange rate movements ( $Z_{t-1} deP_f$ ), the change in imports can be specified as;

2.39

$$dZ_q = \eta_1 d\ddot{y} - \eta_2 deP_f + \eta_2 dP_d + Z_{t-1} deP_f$$

Where  $P_d = dP_f = 1$ ,  $Z_t$  is given by:

2.40

$$Z_t = Z_{t-1} + \eta_1 d\ddot{y} + \eta_2 dP_d + (Z_{t-1} - \eta_2) deP_f$$

Similarly, export volume is assumed to be a function of the relative price of foreign goods in terms of domestic goods. Hence;

2.41

$$X_q = \phi eP_f/P_d$$

Given  $X = X_{t-1} + dX$  and valuation change  $X_{t-1}deP_f$ , the change in exports –  $dX$  is:

2.42

$$dX = \phi deP_f - \phi deP_d$$

Therefore;

2.43

$$X = X_{t-1} + (X_{t-1} + \phi)deP_f - \phi dP_d$$

Foreign capital inflows in local currency are equal to foreign capital inflows in foreign currency multiplied by the exchange rate, that is;

2.44

$$\begin{aligned} F &= eF_f \\ dF &= edF_f \\ dF &= (e_{t-1} + de)dF_f \end{aligned}$$

When the import (equation 2.40), export (equation 2.43) and the net foreign asset (equation 2.45) functions are substituted into the balance of payments identity ( $e_t dR = X - Z + dF$ ), we obtain an extended version of the MABOP models:<sup>17</sup>

2.45

$$e_t dR = [X_{t-1} - Z_{t-1} + dF_f e_{t-1}] + [(X_{t-1} - Z_{t-1} + (\eta_2 + \phi)) P_f - dF_f] de - \eta_1 d\dot{y} - (\eta_2 + \phi) dP_d$$

Equations 2.37 and 2.45 can be rearranged to derive equations for  $dDC$  ( $dDC_p + dDC_g$ ) and  $de$ . This enables to obtain values for these policy instruments by specifying desired values for the target variables  $dP_d$  and  $e_t dR$ . Hence;

2.46

$$dDC = v^{-1} P_{t-1} d\dot{y} + [v^{-1} \dot{y}_t P_f \theta - R_{ft-1}] de + v^{-1} \dot{y}_t (1 - \theta) dP_d - e_t dR$$

And for the exchange rate;

2.47

$$de = e_t dR - [X_{t-1} - Z_{t-1} + dF_f e_{t-1}] + \eta_1 d\bar{y} - (\eta_2 + \phi) dP_d / [(X_{t-1} - Z_{t-1} + (\eta_2 + \phi)) P_f - dF_f]$$

The complete model of FP illustrated above shows where the MABOP reached today. The policy conclusion remains the same, but an additional policy instrument, the exchange rate, now features prominently. Particular emphasis is placed on the expenditure-reduction effect of devaluation, while the level of domestic credit is still a major policy instrument. In sum, IMF's FP framework closely follows the Polak and Chicago models in its monetary and fiscal policies, whereas the absorption approach emerges as a major framework in exchange rate policies. Credit restraint through monetary policies as well as control of government expenditure (under the assumption that domestic credit in developing countries is mainly to the public sector) is a major policy prescription. The role of the absorption approach in IMF stabilisation policies can for example be depicted from the impacts of exchange rate devaluation. The effect of devaluation is on domestic absorption rather than directly on the current account through the real exchange rate effect. In other words the effect of devaluation is to reduce absorption via the real balance effect. This implies exchange rate adjustment is primarily to manipulate international reserves rather than the current account through growth of exports. Devaluation also increases the world price level. This in turn will increase the domestic price level; reduce the real value of financial assets and real wages. As a result wealth and expenditure or absorption fall (IMF, 1987).

## 2.6 Critique of IMF Stabilisation Programmes

The IMF and its FP-based policies in developing countries have been received with criticism in policy making as well as in the international academic circles. The critique, which began in the 1950s and 1960s in Latin America, has been revived through its application in other regions. According to Radha (1995) critics of

adjustment programmes can be classified into four groups: the “eclectics”, the “structural adjustment with a human face”, the “dependency theorists” and the “structuralists”– ranging from a critique of its theoretical inconsistency to its ideological persuasion. Kapur (1998) calls to mind that “if the IMF had a dollar for every criticism of its purpose and role by the Right, the Left, and the Centre, it would perhaps never again have to approach its shareholders for more money to sustain its operations” (p. 115). For instance, Taylor (1988, p. 7) notes the objectives of stabilisation should be:

1. “To maintain socially acceptable levels of capacity utilisation and growth, especially in sectors and regions dominated by their political base;
2. To keep inflation down to a rate tolerable in terms of the country’s own history of price increases and social defences against them – a “tolerable” rate might range from something pretty close to zero in India to 100 per cent in South America’s Southern Cone;
3. To alter national wealth and income distribution in line with their regime’s own ideological predictions and political constraints;
4. To maintain some degree of self-reliance in trade and external financial relationships; and
5. To strive for the first four goals in an environment free from undue economic shocks.”

In summary, the main point of the critique is that the Washington consensus, based on the neo-classical economic rationale, is justifiable neither in terms of the analytical, nor the historical literature. First, it states that macroeconomic disequilibrium, particularly economic difficulties in developing countries, is caused by internal or domestic policy errors. The Washington consensus departed from earlier “dirigiste” strategies through making internal factors largely responsible for economic trends. Its reference to the benefits of development emanates from global experiences, while its explanation of impediments to this objective are confined to internal factors. The assumption is that; first, external disequilibrium is the result of internal policies that allowed aggregate demand (absorption) to exceed aggregate output or income; and, second, exports from SSA, for instance, are always demanded and foreign markets are favourable, but exchange rate overvaluation and trade protection are obstacles to successful export-led growth (Gore, 2000). The orthodoxy treats external causes such as decline in the terms of trade or changes in international monetary policy as having limited responsibility for macroeconomic imbalances. The fact that

declines in the growth rate of low-income countries being associated with the recession in developed economies is ignored. Various studies find that international demand impacts upon export growth for small countries (Faini *et al.*, 1992; Mukhopadhyay, 1999; and UNCTAD, 2000).

The position of the Washington consensus is methodologically untenable. While the case for stabilisation is made from a globalisation point of view (external), the analysis of constraints remains national (internal). On the other hand, ahistoric explanation of success provides the justification for prescribing stabilisation policies, while development can only sensibly be measured through study of structural and societal transformations. As Gore (2000, p. 792) put it:

“rather than combining normative economic nationalism with methodological internationalism, the Washington Consensus was its mirror image. It combined normative economic internationalism with a methodologically nationalist form of explanation which attributed what was happening within countries mainly to national factors and policies (p. 792). The transition from historicism to ahistorical performance assessment started...[since] criterion used to measure performance was current or recent GDP growth rate, and macroeconomic stability, indicated by fiscal and external payments balance and low inflation” (p. 794). The goal of structural transformation has been replaced with the goal of spatial integration” (p. 795).

Second, the approach to stabilisation in developing countries must also be different from that adopted in developed countries. There is dissimilarity in the economic structure of developed and developing countries, which in turn must lead to prescription of different policies. The structure of developing countries or the “standard LDC model” as noted by Porter and Ranney (1982), is characterised by:

- Oligopolistic market structure, which is the result of small non-tradable market and protection of the tradable market from foreign competition;
- Imperfect labour market where nominal wages are fixed in the short run;
- High external dependence related to low elasticity of demand for imports. Imports prices are fixed. Imports and domestic goods are poor substitutes;
- Excess capacity and surplus labour, which implies the absence of diminishing returns to labour. Under-utilised capacity exists because of foreign exchange shortage;
- Pricing is based on variable-cost mark up, which means the profit motive is less apparent;

- The ratio of money to GDP is low and money is largely held for transaction purposes;
- Income taxes are small relative to developed countries;
- Dual financial sector where the curb market is significant in financing investment; and
- Large informal sector.

The above peculiarities of developing economies suggest that the aggregate supply and aggregate demand schedules are different from developed countries (Porter and Ranney, 1982). Application of standard IS/LM analysis to aggregate demand, where equilibrium between the flow of current output and stock of money is established, must also be different in developing countries. The aggregate supply curve for developing countries is flatter and the slope is determined by the cost of working capital (the interest rate) and the exchange rate (through import prices). The demand for money also depends on the exchange rate and the level of wages through their influence on firms' variable costs. The assumption of constant velocity of circulation of money for several countries does not hold. The level of domestic credit and the money supply being below or above real national income is a norm rather than an exception (Green, 1986). Therefore, the LM curve appears to be steeper in developing countries.

As far as equilibrium in the real sector is concerned, the distinctiveness of consumption, investment, government expenditure and net exports in developing countries is clearly borne out. Same as the standard model consumption depends on the marginal propensity to consume and the MPC out of wages is higher than the MPC out of profits. Therefore, consumption is determined largely by labour's share of income and taxes. Investment in developing countries is financed by loans from the formal and the informal sector and the former, under a repressed financial system, is the same as direct government lending or expenditure. Government spending largely consists of wage payments and public sector investment, which is fixed in the short run. The former fluctuates with changes in prices, and falling real wages mean decrease in government spending. On the other hand, export prices are determined exogenously, and the supply elasticities of exports as well as the demand elasticity for imports are small. Trade barriers, taxes/subsidies and the exchange rate also determine



exports and imports. Due to these features of the economy the IS curve is also steeper.<sup>18</sup> Mainstream macroeconomic policy prescriptions, which the Washington consensus rely on produce non-standard results when applied to LDCs (Taylor, 1988).

Monetary restriction and devaluation are particularly suspect, as they are likely to produce both recession and inflation. The use of monetary policy is less effective as the financial sector is underdeveloped. The monetary authorities can use monetary policy as far as changes in the reserve requirement or liquid-asset requirements of commercial banks. They are less able to control the monetary base, which is determined by the budget and current account deficits. Because of the low interest rate elasticity of money demand, an increase in the reserve requirement ratio reduces the money supply and the decrease in the availability of low interest commercial bank loans reduces retained earning. Monetary contraction affects both aggregate demand and aggregate supply. The net impact of monetary contraction is a fall in output and an increase in the price level (Taylor, 19981). These outcomes contrast with the impact on developed economies where output falls and the price level also falls.<sup>19</sup>

The net effect of fiscal restraint is a decrease in the price level and a small increase in output. The latter is because the demand for imports is inelastic and remains unaffected. The fiscal restraint reduces the fiscal deficit, leaving the external balance unaffected. This means that the monetary base is lowered, which brings us back to the monetary effect where output falls. The impact of exchange rate depreciation is also a fall in output and an increase in the price level. Aggregate supply is affected through an increase in variable costs. At the same time devaluation reduces the monetary base. This implies that the stabilisation and adjustment process is not necessarily smooth and has an element of stop and go (Mosley, 1991a). Porter and Ranney (1982, p. 762) conclude:

“the traditional stabilisation policies have very different, and generally less desirable, effects in LDCs than in advanced country models. Most notably, contractionary policy is likely to fuel, rather than dampen, inflationary tendencies...First, it is difficult to attack the balance of payments crisis, except through serious recession to cut back import demand. Second, all macro policies have effects on the government budget and the balance of payments, which affect the monetary base. This in turn severely limits

policy-makers' ability to alter economic conditions in more than the short run. Third, most restrictive policy is likely to worsen the income distribution"

Third, the impact of inflation on growth can, theoretically be established as negative as well as positive. Both Keynesian and monetarist views suggests that inflationary finance can mobilise resources for capital accumulation. The mechanism is through redistribution of income from wages to profit or consumption to savings due to the propensities to save out of profit being higher. According to the monetarist view inflation is a tax on real money holdings, while the Keynesian view is that inflation lowers real interest rates, which in turn raises nominal rate of return on investment. Conventionally, it has been assumed that inflation is equal to the rate of monetary expansion. However, if income is increasing and the demand to hold money is rising at the same time, a portion of the money supply will be non-inflationary (Thirlwall, 1974). On the other hand, unanticipated inflation leads to confusion between relative and aggregate price changes, which lead to the misallocation of scarce resources. Unanticipated inflation also causes uncertainty in future expectation of price and interest rate changes as well as investors' decision (Moosa, 1997). The debate on inflation is far from exhausted and the literature is rapidly growing, while there is no conclusive evidence as far as the harmful effects of inflation are concerned. In the past three decades developing countries witnessed positive growth and at the same time became more prone to inflation (Thirlwall, 1999).

The theoretical debate has led to what might be called *threshold empirical analysis*: an empirical search for an inflation rate above which growth is harmed. Most studies have used cross-section regression analysis similar to that of Barro (1991 and 1996). The econometric evidence on the growth effects of inflation, however, remains inconclusive, mainly related to methodological problems (Temple, 2000). In a study of 127 countries over 1960-1992, Bruno (1995) as well as Ghosh and Phillips (1998) find a positive relationship between inflation and per capita growth up to 5 per cent inflation rate. Beyond this rate per capita growth begins to decline. In a study of 87 countries over 1970 and 1990, Sarel (1996) also finds a positive relationship between growth and inflation up to 8 per cent rate but a negative relationship beyond this rate. Barro (1996) identifies a negative impact on growth above inflation rate of

15 per cent. The finding by Bruno and Easterly (1996) sets the threshold at 40 per cent and shows that “growth falls sharply during the high-inflation crisis” and “growth after the end of the high-inflation crisis was higher than before the crisis, even though inflation had returned to about the pre-crisis level or slightly higher” (p. 213). This confirms the earlier finding that not only high inflation is bad, but also once a higher level is reached there tends to be no return. The high inflation rate will persist and the economy will be characterised by “dynamic instability” (Bruno, 1995).

Stiglitz (1998a) also stresses that it is hyperinflation that policy makers should worry about. In fact, an inflation rate of 40 per cent can be taken as a norm. Focus on the *threshold analysis* neglects an important structural feature of developing economies. This is related to the flexibility of factors of production. If these are rigid, expanding and declining sectors inevitably will be inflationary. In most primary exporting countries, a decline in the terms of trade leads to inflation if wages are downward rigid (Paul *et al.*, 1997). As Stiglitz (1998a) notes “greater humility” is needed on behalf of the Washington consensus for “sometimes misguided” policies and for unduly focusing solely on increases in GDP, macroeconomic stability and prudence, while the focus should have been on improving living standards and eliminating unemployment. Financial conservatism should not be the same as “anti-deficit and anti-inflation radicalism” and balanced budget does not mean zero inflation (Sen, 1998). The absolute inflation figure tells not much and the Non-Accelerating Inflationary Rate of Unemployment (NAIRU), even in the developed economies, was not achieved (Phelps, 1993 and Bruno, 1995). The key lesson is to avoid persistent instability and severe deflation. The question therefore becomes what is the opportunity cost of reducing inflation? Clearly this cost is related to foregone investment in social development.

Fourth, the rhetoric calls for reducing “unproductive” expenditures that do not result in improving basic human needs including military expenditure, subsidies that favour “urban middle classes” and expansion of public employment at the expense of real wage reductions (Tanzi, 1989a, 1994 and Green, 1991). Orthodox programmes, however, have no “human face”: the reduction in public expenditure falls on investment rather than consumption (Cornia *et al.*, 1987).<sup>20</sup> Public investment in

health, education and food subsidies suffer with major implications for poverty. Stewart (1991, p. 1861) found that adjustment policies have contributed to the reduction in “the welfare of the poor, slowing and sometimes reversing progress in nutrition, health and education”.<sup>21</sup>

The above findings are consistent with the experiences of IMF-supported policies, which shift the burden of the crisis onto the poorer segments of society. The urban poor suffer from loss of earnings and are forced to the informal sector to outweigh falling standard of livings (Logan, and Mengisteab, 1993). Reduction in the purchasing power of the real wages and rising unemployment are common outcomes, which in some cases have provoked political reactions (Taylor, 1997). There is naivety and over-optimism in forecasting the performance of an economy in the short-to medium-term, mainly on the expansion of traditional as well as non-traditional exports and the response of savings and investment to financial liberalisation and interest rate policies *plus* expectation of foreign direct investment (Helleiner, 1992).<sup>22</sup>

Similarly, a fall in domestic credit, particularly to the public sector, works against “crowding-in” the private sector as investment on infrastructure is reduced.<sup>23</sup> Strict requirements for fiscal balance are incompatible with increased donor aid for capital expenditure. Often, aid earmarked for investment has to be matched by increased recurrent spending, which often lead to a further increase in taxes. Fiscal austerity for the sake of macroeconomic balance does not take into account high return investments that compensate deficits in the long run through increases in tax revenues (see Alesina and Perotti, 1996 and Addison and Ndikumana, 2003).

The demands of human development and cautionary prudence of financial conservatism are contradictory. Financial conservatism becomes less important where economic and social deprivations are severe. The impact of social development through education and health, for instance, has been given less attention in modern economies when dealing with growth.<sup>24</sup> As Sen (1998) argued Spending on social development contributes *indirectly* to productivity and income increases as well as *directly* by increasing people’s capabilities to accomplish what they could not without literacy and good health. The latter concept is related to the impact of education in

enabling women to enter the labour market, which allows them to gain independence and change their status within the household. Targeted education and health expenditure will bring about a “low-fertility-low-mortality society.” Per capita income increases tell us nothing about changes in quality of life, inequality and demographic change. Broadening of social development also widens the benefits gained from increased social spending. This in turn makes financial conservatism less appealing and the emphasis on human capital as a factor input in the growth process has sidelined the importance of social “development as freedom” (Sen, 2001).

There is an “implicit prejudice”, which suggests that human development is “a kind of luxury that only richer countries can afford”. However, human development is pro-poor and financial conservatism should be the “nightmare of the militarist, not of the school teacher or the nurse” (Sen, 1998, p. 739-40). A large budget deficit may be a response to the low level of business activity, leading to reduced government revenues and higher government transfers, as in the case of most low-income countries. The Washington consensus, however, mistakenly sees the budget deficit as adding to demand at a higher level of employment (Dell, 1982).<sup>25</sup> As Sachs (2000) notes:

“[T]he IMF starts with the truth that budget deficits should remain small in order to preserve macroeconomic stability. Then it demands budgetary austerity of impoverished countries to the point where those countries can’t even keep their poor alive—so depleted are the budget resources for public health, food transfers to the poor, and the like. In addition, the IMF has repeatedly insisted on debt servicing that exceeds the combined spending of the health and education ministries. And yet, when the world complains about the disasters of IMF conditionality, the IMF’s response is that the protestors are obviously macroeconomic illiterates” (p. 3).

The time span for short-term deflation to be offset by long-term growth and whether the same groups affected by short-term adjustment costs gain in the long-term is also unknown (Addison and Demery, 1985 and 1987). It is not clear how poverty, which is more often than not a result of dysfunction in the labour market (unemployment and low wages), can be eradicated in a model where full employment and perfectly working labour markets are the underlying assumptions. The Washington consensus is stuck with the idea that growth suffices to reduce poverty,

regardless of the assumptions and where no targeted subsidies, credit and social safety nets exist. In the case of SSA, for instance, the arguments contained in OAU (1981) and UNECA (1989), which pointed out that the importance of food self-sufficiency, industrial and human resource development, regional trade expansion, diversification of exports, food subsidies, are not taken into consideration.<sup>26</sup> The policy of restraining domestic credit flows results in shortages of working capital and reduction in investment. As noted by Tarp (1993, p.63) "no account is taken of the fact that credit expansion may be linked through policy with investment and capital accumulation, which might have positive effects of their own." Rhomberg and Heller (1977, p. 4, quoted in Fine and Hailu (2001), state;

"The apparent simplicity of the monetary approach to the balance of payments is, however, deceptive. Even for many purposes the demand for money can be conveniently expressed as a function of a small number of variables, it is still just as much the resultant of all the influences that come to bear on the economy, as are national income and expenditure. Again, domestic credit, which is often taken as being determined exogenously, may in fact be systematically influenced by factors determining the demand for money or by some of the events whose monetary effects are being examined. These considerations do not invalidate the monetary approach; they merely draw attention to the possibility that it will be seen, on further examination, to be not quite so superior in terms of simplicity of application as had first been thought".

Finally, devaluation increases import prices and the consequent fall in absorption could have negative effects on investment and output. As the demand for imports by developing countries tends to be inelastic, the absence of local alternatives for industrial as well as agricultural inputs is what makes the demand for imports less responsive. Dependence on imported capital and intermediate goods as well as fertiliser inputs is not recognised within the FP framework. Influential studies have shown that devaluation has serious distributional implications as propensities to save differ between low-income urban wage earners and high-income profit earners (Krugman and Taylor, 1978; Loxley, 1986 and Taylor, 1988 and 1993b). As Helleiner (1983a) put it: the "short- to medium-term burden of adjustment inevitably fall disproportionately upon income and the volume of imports" (p. 352).

## 2.7 Concluding Remarks

In this chapter it has been shown that the conceptual framework associated with IMF financial programming has evolved from the simple Polak model to a complete model of stabilisation applied to correct macroeconomic imbalances, mainly the deficit in the external sector by demand-side measures. In IMF's vocabulary: 1) high inflation rates discourage savings and investment and, as a result, economic growth slows down; 2) an overvalued exchange rate undermines competitiveness of exports and import substitutes; and 3) expansion in domestic credit, particularly to the public sector, is a culprit in accelerating inflation and current account deficits. Crudely put, the policy implications are to devalue the nominal exchange rate to achieve export competitiveness, restrain domestic credit to control inflation and simultaneously achieve real exchange rate depreciation as well as an improvement in the reserve position. If these policies succeed, there will be an improvement in current account deficits as exports rise and imports fall. This process is aided by a fall in demand for imported goods caused by devaluation. This simultaneous relationship between external and internal resource gaps can simply be demonstrated as follows;<sup>27</sup>

$$2.48 \quad Z - X = (I - S) + (G - T)$$

Equation 2.48 shows that an internal disequilibrium caused either by a shortfall in savings or low level of tax revenue is reflected by disequilibrium in the current account and vice versa. Shortfalls in savings (high level of consumption) can be financed by external borrowing. In stabilisation programmes, however, it is not clear how external financing is sustained as resulting increases in investment may not necessarily increase capacity to service debt. On the other hand, if external borrowing is used directly to finance investment, at least the marginal return from it must be greater than the cost of borrowing. IMF stabilisation programmes seem to doubt the capacity of most developing economies to generate such a return in the short-term. Specifically, external borrowing above assumed sustainable levels is not an option in stabilisation programmes simply because reduction of debt burden itself has become an objective to which targets are set. Similarly, taxation cannot be increased in the short-term as it requires structural policies to increase income, not least the problem of

low tax base in most developing countries. As a result of the rural, small-scale character of production and distribution, particularly in SSA, most market transactions go unmonitored by the authorities. Even legal transactions are virtually impossible to measure directly.

As clearly indicated in earlier studies from IMF staff (Khan and Knight, 1981 and Zulu and Nsouli, 1985, Khan, *et al.*, 1990), the short-term feasible policy in the typical stabilisation programme is to reduce aggregate consumption and investment commonly referred to as aggregate demand or absorption. This is a typical orthodox policy recommendation, which tackles price increases and the demand for imports via reduction of aggregate demand. The logic is that a fall in aggregate demand leads to a decline in the price of non-tradable goods and services. It follows that prices of tradable goods and services rise relative to non-tradable goods and services, this in turn leads resource shifting into export and import substituting sectors. In the FP framework domestic credit is a key policy variable for deflationary policies. The complete model of FP brings in the exchange rate as another crucial policy variable. The effect of devaluation, mainly through the real balance effect or in reducing domestic absorption, is part and parcel of the stabilisation package. This is based on the assumption that exports do not quickly respond to exchange rate changes.

FP is essentially a short run monetary model with significant deflationary implications. The reduction in the level of credit to the public sector results in shortages of working capital and fall in public investment, particularly in social services. The demands of human development and cautionary prudence of financial conservatism are contradictory. The Washington consensus inspired stabilisation policies are not valid neither in terms of the analytical nor the historical literature. External and internal imbalances are not necessarily the result of inflated absorption, but the direct result of the capacity to increase supply. The standard deflationary policies applied in developed countries do not work in developing countries, mainly due to their particular structural features. Mainstream macroeconomic policy prescriptions produce non-standard results when applied to developing countries. The net effects of monetary contraction are falls in output and increases in price levels.



The attempt to solve the balance of payments crisis and inflationary pressures with severe deflation reduces output and worsens income distribution.

Whether the Washington Consensus results in a superior economic performance has been seriously questioned in the literature. As Dornbusch (1990, pp. 42) noted: stabilisation is “not a ticket to prosperity.” In response to the critique, the IMF began to extend its short-term demand-side stabilisation concern into medium- and long-term supply-side issues. As will be shown in the next chapter, this took place via embracing mainstream orthodox supply-side economics, both conceptually and in policy.

## Notes

<sup>1</sup> Polak (2001) also argues that the Fund or the “Washington” model is Keynesian and dubs it the “evolutionary” approach. Polak also refers to the Chicago model as “Johnsonian”, after Harry G. Johnson and calls it the “revolutionary” approach.

<sup>2</sup> Bird (1997) points out:

“There is, of course, a problem here since economists do not fully understand what it is that determines economic growth. Nor is there a consensus about how economies work, or whether they all work in the same way. This is highlighted by the debate between “new classical” and “new Keynesian” macroeconomics with the latter argument that prices are “sticky” in the short run. Excess confidence in a particular model therefore reflects more of an article of faith on the Fund’s part than a scientific judgement. It is this excess confidence, captured by the Fund’s willingness to be exceedingly precise in terms of the quantification of macroeconomic policy targets, that is a source of concern, as well as a source of conflict between the Fund and borrowing countries” (p.186).

<sup>3</sup> Williamson (2000) notes that “I invented the term “Washington consensus” to refer to the lowest common denominator of policy advice being addressed by the Washington-based institutions to Latin America countries” (p. 251).

<sup>4</sup> See Tarp (1993) and Khan *et al.* (1990) for analysis of sectoral income and expenditure for the four major sectors.

<sup>5</sup> Under the assumption that consumption is the function of disposable income and real wealth ( $C = f(Y, W/p)$ ), consumers respond to increases in prices and the following decrease in wealth by reducing future consumption.

<sup>6</sup> Income that is not used for consumption is saved i.e.  $Y - C = S$

<sup>7</sup> From  $\Delta M = e_t dR + \Delta DC$ , it follows  $\Delta M - \Delta DC = e_t dR$

<sup>8</sup>  $X - Z = Y - A$

<sup>9</sup> See Blejer *et al.* (1995) for an account of the IMF’s research activities and the contribution of its publications to international economics.

<sup>10</sup> In the economics profession the tradition has always been to analyse macroeconomic issues under the assumption of perfect product and factor markets. However, there exists a literature that does highlight imperfectly competitive product and factor markets in macroeconomic analysis associated with Aswicahyono *et al.* (1995), Ng (1980 and 1982), Hillier *et al.* (1982), Hart (1982), Dixon (1987), Blanchard and Kiyotaki (1987), Mankiw (1988), Stiglitz (1989), Manning (1992), Dixon and Ranking (1994), Damania and Madsen (1995), Rotemberg and Woodford (1992) and many others. These studies are meant to correct assumptions of Walrasian competitive markets in microeconomics, which are the basis to build on the neoclassical as well as Keynesian macroeconomics (see Blanchard and Kiyotaki, 1987 and Mankiw, 1988). However, these studies, besides being theoretically complex, mainly focus entirely on developed countries.

<sup>11</sup> For the sake of consistency, notations of variables may be different from the original Polak (1957) paper.

<sup>12</sup> See Tarp (1993, p. 61)

<sup>13</sup> Without providing clear reasons, most writers argue that imports are functions of present income rather than income from the previous period. Here, we use  $Y_t$ , because  $dY_t$  can be significant and cannot be ignored as in the Polak model (note:  $Y_t = dY_t + Y_{t-1}$ ). Polak (2001, p. 6) restates that;

“No explicit lags are shown in the behaviour equations, but the model acquires its dynamic character from the fact that while the flow variables in it ( $Y, Z, X, F$ ) are measured as totals over the unit period selected; the shock variables ( $M, R$  and  $DC$ ) are measured as amounts outstanding at the end of the period.”

The notations of the variables in this quote are different from Polak (2001). This is meant to make them consistent with the rest of the notation in the thesis.

$$^{14} Y_{t-1} = Y_t - dY_t$$

<sup>15</sup> In Khan *et al.* (1990) it is assumed  $dP_t d\tilde{y}_t$  are “small, so the second-order term”  $dP_t d\tilde{y}_t$  “can be neglected” (footnote 10, p. 159). Tarp (1993) on the other hand, argues, “since  $y$  is an exogenous variable that is projected separately, this assumption is not necessary” (Note 42, p. 181).

<sup>16</sup> See Tarp (1993, p. 60) for further discussion of the Chicago model.

<sup>17</sup> Khan *et al.* (1990) assume that  $dP_f = 0$ ,  $P_f = 1$  and  $e_{t-1} = 1$ .

<sup>18</sup> Therefore the aggregate demand curve for developing countries is also steep.

<sup>19</sup> The increase in the price level in LDCs is because of the flatness of the aggregate demand curve. Monetary contraction moves the aggregate demand curve towards the origin, but it is insignificant to lower the price level. Monetary contraction also moves the aggregate supply curve upwards though the increase in the interest cost on variable inputs. Restrictive fiscal policy such as decrease in government spending shifts the demand curve towards the origin and the aggregate supply curve downwards. The impact of exchange rate depreciation is to shift the aggregate supply curve to the origin and the aggregate supply curve upwards.

<sup>20</sup> For the literature on the impact of macroeconomic policy on income distribution and poverty see Knight (1976), Dervis, de Melo and Robinson (1982), de Melo and Robinson (1982), Johnson and Salop (1980), Sisson (1986), Kanbur (1987), Harriss and Kusi (1992), Bourguignon and Morrisson (1992), Sahn (1992), Killick (1995b), Sarris (1996), Elson and Cagatay (2000), and Dollar and Kraay (2000).

<sup>21</sup> Others highlight:

“Whatever we may conclude about distributional effects, there must be a strong presumption that, other things being equal, macroeconomic contraction will worsen poverty. While the relationship is not tight, and there is a room for offsetting policies, there must be a presumption that the greater

is the reduction in overall absorption the greater is the adverse impact upon poverty" (Helleiner, 1987, p. 1506).

"It does not always follow, however, that those who bear the short-run costs of adjustment will also benefit from the advantages of improved growth performance should it occur" (Addison and Demery, 1987, p. 1495).

<sup>22</sup> Stiglitz (1998b) argues the previous development strategies:

"Most of these have focused narrowly on *economics*. Economics is important: after all, one of the features, which distinguish more developed from less developed countries, is higher GDP per capita. But the focus on economics has confused not only means with ends, but cause with effect. It has confused means with ends, because higher GDP is not an end in itself, but a means to improved living standards and a better society, with less poverty, better health, and improved education" (p. 5) "saw development as a *technical* problem requiring technical solutions-better planning algorithms, better trade and pricing policies, better macroeconomic frameworks. They did not reach deep down into society, nor did they believe such a participatory approach was necessary. The laws of economics are universal: demand and supply curves and fundamental theorems of welfare economics applied as well to Africa and Asia as they did to Europe and North America. These scientific laws were not bound by time or space" (p. 7).

<sup>23</sup> Taylor (1988, p. 20) points out:

"What usually happens under a demand-reduction programme is that the price mechanism is short circuited. The cut-back in real purchases makes production fall, cutting import needs directly...Indeed by holding down domestic investment, austerity may make repatriation of foreign incomes unattractive."

<sup>24</sup> Sen (1998) notes that Adam Smith (1976) dealt with the concept of human capital and highlighted the importance of skills and specialisation. Later Harrod-Domar and Neoclassical theories of growth, however, put aside the importance of human capital. The issue once again became the focus of attention with the advent of endogenous growth theory (Romer, 1987).

<sup>25</sup> The critical questions are: what are the consequences of reducing aggregate demand? And who is taking the burden of such contractions in absorption? As Dell (1982) notes:

"A permanent solution to the problem of cost inflation cannot be obtained by seeking to play on the fear of rising unemployment among those who try to protect themselves against increases in the cost of living by demanding higher wages (p. 599). Demand deflation, if taken far enough, will ultimately have an impact on cost inflation – there is no dispute about that. What is in question is the need for the heavy social and economic costs that are involved" (p. 608).

<sup>26</sup> Collier (1998a, p. 5) notes:

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“Whereas growth will eliminate *mass* poverty, and well-designed growth policies will eliminate it quite rapidly, there are important groups for whom growth will not be enough. That is why all developed societies have evolved sophisticated public welfare, health and pensions programmes. The design of redistribution systems, and especially of quick-acting social safety nets, in low and middle-income countries will require a lot of skill.

<sup>27</sup> The equation is obtained by manipulating the national balance equation ( $Y = C + I + G - T + X - Z$ ).

## Chapter 3

### IMF Adjustment Programmes: Supply-Side Policies

#### 3.1 Introduction

As shown in the previous chapter, the initial economic model attached to financial programming is associated with FP, which formulates relationships between domestic credit expansion, income and the balance of payments. In response to criticism the IMF sought to address supply-side issues via two avenues. The first involved a union between the IMF and the World Bank, through a less successful conceptual “marriage” between the IMF’s FP and the World Bank’s Revised Minimum Standard Model models (Khan and Montiel, 1989 and Khan *et al.*, 1990). FP primarily focuses on stabilisation of the balance of payments and prices within a monetary framework. In contrast, the RMSM focuses on growth through investment dependent on domestic savings and external finance aided by removal of trade and other market barriers (see Chenery and Strout, 1966). The idea behind formulating a merged model is to address limitations of the two models. The merged model endogenises real output, which the FP model does not, and also determines prices, which the RMSM does not. The merged model has four instrument variables: taxes, government consumption, the level of domestic credit, and the exchange rate and target three variables: income, prices and the level of reserves. The model is then used to determine values for the endogenous variables and the three policy instruments (Khan *et al.*, 1990). Operationally, the functions of the IMF and the World Bank overlapped. While the IMF began to restate structural issues the World Bank began to stress the importance of macroeconomic stabilisation (see Mosley *et al.*, 1995 and Krueger, 1998b).

However, it is not clear how complex issues such as growth can be captured with such simple restrictive models in the first place and the subsequent more complicated merged model (Polak, 1990). The short run stabilisation content of the model is still overriding with no growth dynamics supplied. The model does not have a long run

steady-state solution as growth from increased exports and other exogenous factors are excluded. Even if the model is corrected for steady-state balanced growth, it turned out to be unsound and unsuitable for examining long run adjustment issues (Fine and Hailu, 2002).

Second, besides the attempt to merge the IMF's and the World Bank's models, mainstream supply-side policies were embraced to address long run adjustment issues. Although these policies do not appear as coherent models, they are based on mainstream economics that emphasises on the expenditure-switching aspect of devaluation, financial and trade liberalisation, and privatisation. In a recent survey Goldstein (2000, p. 4) defines IMF's structural programmes as:

“policies aimed not at the management of aggregate demand but rather at either improving the efficiency of resource use and/or increasing the economy's productive capacity. Structural policies are usually aimed at reducing/dismantling government-imposed distortions or putting in place various institutional features of a modern market economy. Such structural policies include, inter alia: financial sector policies; liberalisation of trade, capital markets, and of the exchange rate system; privatisation and public enterprise policies; tax and expenditure policies; labour market policies; transparency and disclosure policies; poverty-reduction and social safety-net policies; pension policies; corporate governance policies (including anti-corruption measures); and environmental policies”.

The structural or supply-side policies of adjustment programmes stem from the assumption that economies that need adjustment exhibit distortions in the general equilibrium sense. The argument is as follows: government interventions that go beyond correcting private distortions, as in the supply of public goods for instance, but fail to correct them, are welfare-reducing in a Pareto optimum framework. Hence, eliminating government interventions that do not correct market distortions is welfare-raising. Towards the mid-1980s, therefore, the IMF started to complement its short-run stabilisation models with long-term adjustment policies (Demery, 1994).

The first supply-side policy is based on interest rate adjustment in the financial sector drawing on the hypothesis laid by the financial repression models of McKinnon

(1973) and Shaw (1973). These models propose that allowing real rates of interest to rise to their market clearing level stimulates higher savings and investment, both through raising the average efficiency of investment and by enabling rationing of low-yield investment projects. Financial liberalisation is seen as a reversal of “repression” that taxed and distorted the sector through interest rate controls and directed credit allocation programmes. Repression makes financial assets, especially bank deposits unappealing and lead to low level of financial flows into the banking system (World Bank, 1989b and Fry, 1980, 1997).

The foundations for financial liberalisation are weak. Saving and investment do not always equate and a rise in the former does not necessarily imply increased investment. Investment depends on expectations of future demand and prices do not clear instantaneously. Effective demand is determined by social conflicts and the resulting income distribution (Burkett and Dutt, 1991). The assumption of the auctioneer and the absence of institutions are major deficiencies of the model (Stiglitz and Weiss, 1981 and Stiglitz, 1989, 1993). Country experiences show that financial liberalisation was aborted in many Latin American economies due to its negative consequences (Capiro *et al.*, 1994). While governments in East Asia influenced interest rates, managed credit allocations as well as the flow of credit to the export-sector (Wade, 1990 and Amsden and Euh, 1993). Liberalisation fails to address the particularities of community based local networks and traditional familial relationships within grassroots financial transactions (Aryeetey and Nissanke, 1998).

Another core component of IMF supply-side adjustment programmes is trade liberalisation, based on the idea that countries would benefit from maintaining their higher share in exports (Ranis, 1985 and Helpman and Krugman, 1985). This implies that high cost and low productivity economies will fall short of reaping the gains from trade (Dornbusch, 1974). The model under which the above interactions take place is a general equilibrium model, built upon the choices of individual agents interacting solely through the market (see Krueger, 1998a). The hypothesis is that trade liberalisation reduces anti-export bias and makes exports, more competitive in international markets, mainly by



reducing exchange rate distortions and export duties (Bhagwati, 1988 and Bhagwati and Srinivasan, 1999). Trade liberalisation not only increases the volume of goods and services traded, but also benefits the economy through knowledge embodied in the products traded (Grossman and Helpman, 1991 and Rivera-Batiz and Romer, 1991). Trade liberalisation improves economic performance and positively affects the poor in developing countries due to their special structural features (Buffie, 2001). Thus, the IMF encourages trade regimes that usually include the adoption of a low, uniform tariff structure which provides equal effective protection to all producers of tradable goods and the elimination of QRs such as quotas, bans, export and import licensing, and state trading monopolies.

However, prices do not necessarily reflect social-costs as the proponents of free market advocate. Imperfections are related to factor markets associated with inter-sectoral wage differentials, divergence between market and shadow wages as well as sector-specific minimum wages (UNCTAD, 1989; Agosin, 1991; and Rodrik, 1992). Many studies find no significant impact of trade liberalisation on export performance and showed the structural limits of trade liberalisation on export growth (Shafaeddin, 1994; Harrison and Hanson, 1999; and Thirlwall, 2000). A recent survey of the empirical literature has shown that the direct link between trade liberalisation and economic growth is ambiguous, mainly due to suspect methodology and confused econometric analysis that failed to distinguish exogenous and endogenous sources of growth (Rodríguez and Rodrik, 2001). The success of openness depends mainly on how comparative advantage is aided by other sector-specific policies. Examples are research and development expenditure, technological advances, and improving quality of products (Sachs and Warner, 1995 and Amsden, 1997). Liberalisation in sub-Saharan African economies has not been followed by favourable responses because the reforms needed to ensure that world prices are transmitted to producers were not in place (McKay *et al.*, 1997 and Winters, 2002).

The third supply-side policy, which the IMF adopted, is exchange rate depreciation for expenditure-switching via encouraging production for export. The idea is

that currency depreciation increases foreign demand for exports and raises the domestic demand for and supply of import substitutes (Bird, 1983). The case is based on the experiences of many developing countries where the overvaluation of the exchange rate is seen as pro-imports and anti-exports (IMF, 1987). Another argument for devaluation is related to rent-seeking and wasteful administration activities typically encouraged by overvalued exchange rates and the associated import licenses and exchange controls (Krueger, 1974). Overvaluation of the exchange rate also induces capital flight among domestic citizens anticipating further devaluation. As a result, less foreign exchange is available for imports (Sachs and Larrain, 1999 and Shatz and Tarr, 2002). Exchange rate overvaluation affects productivity gains and hence growth negatively (Edwards, 1989 and Cottani, *et al.*, 1990). These findings have also been ascribed to low growth, low investment, low level of savings, and low-level of trade in SSA (see Ghura and Grennes, 1993; Elbadawi and Majd, 1996; Clément, 1994; and Azam and Devarajan, 1997).

However, the assumption that exports and imports are responsive to prices so that capital and intermediate goods could be substituted without causing disruptions in investment and output is unrealistically based on perfect mobility of factors of production. The structural rigidity or flexibility of developing economies is not taken into consideration (Taylor, 1993a and 1993b). Inflation and balance of payments problems are inherently related to the structure of production and distribution in an economy and the response of primary exports need more than just relative price changes. Policies such as investment programmes and targeted subsidies must be considered (Taylor, 1997). Devaluation sidesteps the production side of the economy required for building a modern and competitive production base through firm-specific knowledge, differentiated products, patents, scale economies, externalities, research and development (Amsden, 1997). There is danger of a fallacy of composition effect in manufacturing (Cline, 1982 and UNCTAD, 2000) as well as agricultural exports (Bleaney, 1993; Akiyama and Larson, 1994; Schiff, 1995; and Weeks, 1995). Little evidence was found to substantiate the claim that exchange rate liberalisation has removed the bias against exports, thus encouraging export expansion to fuel economic growth in SSA economies (McKay *et al.*, 1997).

The fourth supply-side policy, which the IMF embraced, is privatisation. The objectives are to foster private sector participation, improve the efficiency of enterprises, and create a competitive environment, and improve the government's fiscal position (Cambell-White and Bhatia, 1998). Public choice, property rights and principal-agent theories provide the justification to pursue the transfer of public assets to the private sector (Vickers and Yarrow, 1995). These theories assume that internal efficiency at a firm level and allocative efficiency at economy wide level hold through equating of prices with marginal costs. At the same time the government's fiscal balance improves through gains from sale of enterprises, savings made from subsidising unprofitable enterprises, and new tax revenues from the privatised enterprises (Cambell-White and Bhatia, 1998). In most SSA countries state-owned enterprises have been privatised on the basis that they performed poorly, mainly through political interference in management decisions as well as protection from competition (Tangri, 1995).

However, theories of privatisation are unduly pessimistic about the motivation of state-run enterprises, which often guarantee access to basic services by low-income groups. The experience of privatisation suggests that there is no evidence that ownership by the private sector is superior over ownership by the public sector as far as efficiency of enterprises is concerned (Berg and Shirley, 1987). Private ownership is not necessarily better and large private enterprise can equally be bureaucratic and extremely inefficient (Chang and Singh, 1993 and 1997). Privatisation actually leads to concentrated market structure, mainly due to scarcity of capital, as confirmed by increasing interest shown to purchase less competitive industries (Commander and Killick, 1988 and Kikeri *et al.*, 1992). Privatised firms can also be inefficient and bureaucratic due to the "free-rider" problem in shareholder monitoring. Widespread ownership makes monitoring firm operations difficult (Fine, 1997). The experience of SSA is consistent with findings in other regions, which shows that fast privatisation was found to be not effective (see Stiglitz, 1998a; Solnick, 1998; and Nellis, 1999). In general, privatisation in SSA has been hasty and careless, where weak post-privatisation regulatory frameworks,

undermine its success (Ramamurti, 1997; Cramer, 2001; and Castel-Branco, Cramer and Hailu, 2003).

The rest of this Chapter is organised as follows. Section 3.2 examines how the merged model of the IMF is constructed and shows how it fails to emerge as a “growth-oriented” model for IMF programmes. Section 3.3 discusses the merits of financial liberalisation and its constraints. Section 3.4 extends the discussion of IMF supply-side policies and examines trade liberalisation, doubting its applicability to primary commodity producing low-income countries. Section 3.5 will turn to argue that, exchange rate policy, which is meant for expenditure-switching fails to materialise. Section 3.6 discusses the privatisation experiences of developing countries to demonstrate how the private sector alone cannot tackle major structural issues. Concluding remarks are provided in Section 3.7

### **3.2 The Search for a “Growth-Oriented” Model**

Towards the mid-1980s an attempt was made to eliminate the link between short-run stabilisation measures aimed at “restoring balance of payments' equilibria” and longer-term measures aimed at “reforming the structure of an economy and increasing growth rates”.<sup>1</sup> In operational terms, the introduction of the Structural Adjustment Facility (SAF) in 1986, mainly destined for the least developed economies, was the first sign of a move towards addressing structural constraints in the balance of payments position. Similarly, the establishment of the Enhanced Structural Adjustment Facility (ESAF) in 1987, and renamed Poverty Reduction and Growth Facility (PGRF) in 1999, signalled a change in rhetoric. According to the IMF the objective of SAF and ESAF programmes, which address supply-side issues, are: 1) raising saving rates; 2) securing financial stability; 3) liberalising and opening economies to foreign trade; 4) reducing state intervention and making markets more efficient; 5) reorienting government spending and improving revenue collection; and 6) mobilizing external resources (IMF, 2001a and 2001b).

The IMF's move towards a more supply-oriented adjustment is the reflection of the thinking in the profession in the early to mid-1980s as well as a response to criticism of FP as described in Chapter 2. Even for Polak (2001, p. 15) the approach:

“by focusing on the *balance* of payments as residual, it turns a blind eye to exogenous impulses originating in the balance of payments. With exports, and more recently also capital movements, as the dominant autonomous determinants of all the largest economies, any approach that ignores these aspects risks incurring a heavy cost in terms of relevance.”

The new thinking and criticism focused on supply-side policies as more conducive to output expansion than demand deflation that could cause *irrecoverable* decline in output in the short-term. Moreover, the political change in Central and Eastern Europe as well as Soviet Union allowed the IMF to engage in extensive transition and transformation of economic systems (IMF, 2001b). Structural adjustment after the 1981 Berg Report was a terrain left to the World Bank while short-term stabilisation was that of the IMF (see Mosley *et al.*, 1995).<sup>2</sup> The conventional distinction between the former's role as a development and project lender and the latter's balance of payments financier is no longer applicable. Krueger (1998b) sites one example of the beginning of joint thinking by the IMF and the World Bank: by order of the United States, the World Bank was lending to Argentina in the mid-1980s while the IMF refused on grounds that the macroeconomic policies were not in line with its prescriptions. This has led to the decision by the Boards of the two institutions to co-ordinate their lending policy and produce joint papers when a country needs assistance. According to Killick (1995a, p.76), the move towards supply-side adjustment by the IMF;

“could also be seen as a Fund response to the movement by the World Bank into the area of macroeconomic policy, with the growth during the 1980s of its structural adjustment lending; and the increased growth of the debt problems in the early 1980s, with an associated emergence for the first time of a problem of countries falling into arrears in servicing their past IMF credits.”

The union between the IMF and the World Bank took two forms. The first, and less publicised, union between the IMF and the World Bank was on conceptual ground to

“marry” the FP model and the Revised Minimum Standard Model (RMSM) of the World Bank, an earlier version of which is found in Chenery and Strout (1966). The objective is to formulate a framework for “growth oriented adjustment programmes” or consolidate the short-term models of the IMF with long-term supply side models (see Khan and Montiel, 1989 and Khan *et al.*, 1990). The second involved both institutions crossing each their traditional territory and when the IMF began to provide lending and advice in financial, trade and exchange rate liberalisation as well as privatisation.

### 3.2.1 The World Bank Model

According to Khan *et al.* (1990, p. 175-176) the idea behind formulating a merged model lies in that the “integration of the Fund and Bank approaches into a unified model goes a considerable way towards addressing what are perceived to be the principal weakness of the two models.” The merged model endogenises real output, which the FP model does not and also allows the determination of prices, which the RMSM does not address. Similarly, while the FP leaves output to be determined exogenously by a neoclassical aggregate supply function, the merged model assumes output to be determined endogenously by the Harrod-Domar production function. Others attempted to merge the FP framework with some sort of output models in an attempt to relax the assumption of exogenous determination of output. The paper by Chand (1989) extended the basic FP model by treating nominal income as endogenous within the FP framework itself. A more recent paper by Mikkelsen (1998) conducted an empirical exercise for El Salvador using the FP models with a neoclassical model of output determination. As discussed below the merging of the FP and RMSM models, however, received little attention and remains unrealistic both conceptually and operationally.

Financial programming of the type set out in the previous chapter primarily focuses on stabilisation of the balance of payments and prices within a monetary framework. In contrast, the World Bank’s RMSM focuses on growth through investment dependent on domestic savings and external finance aided by removal of trade and other

market barriers (see Chenery and Strout, 1966). The model of growth associated with RMSM is the Harrod-Domar production function in which constant returns to production is assumed and the incremental capital-output ratio (ICOR) is given by a fixed coefficient. Full employment is the long run equilibrium, which means that the amount of investment needed to catch up with the natural rate of growth is also exogenously derived by the growth of the labour force ( $n$ ). Hence, if the economy is to stay at its long run equilibrium, it must follow a steady-state balanced growth (SSBG) where the warranted rate is equal to the natural rate of growth. This can be seen from the following expressions, where  $s$  is the saving rate,  $\alpha$  is incremental capital-output ratio, the warranted rate of growth,  $s/\alpha$  is given by;

3.56

$$s/\alpha = n$$

Although SSBG implies that the rate of growth of all variables remains constant, it became clear that this may not hold as the rate of growth of the labour force, the savings rate and the ICOR are determined independently of each other. Hence, the possibility of SSBG occurring becomes a question. The problem is not only of SSBG's existence but also its stability. The warranted growth rate is tied to the rate of savings and incremental capital-output ratio (ICOR). Where investment is also equal to savings, income is given by;

3.57

$$d\bar{y}_t = \alpha^{-1} dK$$

$$dK = \alpha Y_t - \alpha Y_{t-1}$$

Equation 3.57 shows that the growth rate is positively related to the investment or savings ratio and negatively related to the ICOR. In other words as the economy saves and invests out of its given income the higher its growth rate will be. As noted above, the growth rate of the economy is related to the growth rate of the labour force, which is

fixed by various factors some of which are non-economic. The model's assumption is that for full employment of labour with growing productivity, output must grow at the same rate as labour. Thus, SSBG is a special case where;

3.58

$$d\bar{y}_t = \alpha^{-1} dK = n$$

To guarantee the SSBG,  $s$ ,  $\alpha$ , and  $n$  must be varied. Even if these policy options are possible, the stability of SSBG cannot be guaranteed leaving the whole process on the "knife-edge" as the rate of growth varied from the ratio of savings to ICOR. The economy grows at a rate that may be inflationary when it is greater than capacity or unemployment when it is below capacity. This implies that SSBG relies on the assumption that increases in demand will grow in line with changes in the capital stock. The instability problem arises as firms, who are unable to predict the growth of demand accurately, do not adjust the capital stock. This problem is also associated with the assumption of fixed parameters in the model. For policy purposes, influencing the growth of the labour force in the short-run is not feasible as broad social and economic policies are negotiated. This leaves the ICOR and the savings rate as viable policy alternatives. The mechanisms by which changes in the saving rate can take place are suggested by many such as Kaldor, who divided savings into portion saved by workers and capitalists (see Fine and Murfin, 1984). However, the Harrod-Domar growth model does not take the contribution of technical progress into consideration implying no convergence or catching up by developing economics. The model is too aggregate and no structural change is shown.

The World Bank's RMSM is based on the variations in savings, but relies on the framework put forward by the Harrod-Domar model. Where  $Y_t$  is treated as real output, from the national accounts identity and where the import function is given by equation 2.21 in Chapter 2 ( $Z_t = \mu Y_t$ ), investment can be specified as;



3.59

$$dK = (Y_t - C) + (\mu Y_t - X)$$

Equation 3.59 implies that investment has two components: domestic savings ( $S_d = Y_t - C$ ) and foreign savings ( $S_f = \mu Y_t - X$ ). Therefore, domestic savings as a function of changes in income is given by;

3.60

$$S_d = (\alpha + \mu)dY_t - \mu Y_{t-1} + X$$

Equation 3.60 determines what is commonly referred to as the “savings-gap” or the amount of savings required to sustain the growth of output. Where  $S_A$  is autonomous savings, domestic savings can alternatively be specified as a behavioural function as follows

3.61

$$S_d = S_A + sY_t \quad 0 < s < 1$$

In addition to the volume of savings determined by the savings rate ( $s$ ), the autonomous savings required to maintain an increasing capacity output is given by; (see Agénor and Montiel, 1996);

3.62

$$S_A = (\alpha - (\mu + s))dY_t - (s - \mu)Y_{t-1} + X$$

Khan *et al.* (1990) expanded the above analysis by introducing a consumption function and disaggregating savings into private, public and foreign sectors. Therefore;

3.63

$$C_p = (1 - s)(Y_t - T_d)$$

Substituting equation 3.63 and the import equation ( $Z_t = \mu Y_t$ ) into the national identity equation and solving for  $dK$  yields;<sup>3</sup>

3.64

$$dK = (s - \mu)Y_t + (1 - s)T - C_g - X$$

The “foreign exchange gap” in this two-gap model can be calculated from the balance of payments equation ( $dF = X - Z - de_tR$ ). This is done by modifying the import and export functions as follows: where  $\beta$  and  $\delta$  are parameters.

3.65

$$Z_t = \mu Y_t - \beta e$$

And

3.66

$$X = \delta e$$

Therefore, the foreign savings ( $dS_F$ ) required to sustain increments to output is specified as follows:

3.67

$$dS_F = -\mu Y_t + (\beta + \delta)e - e_t dR$$

Substituting the modified import function (equation 3.65), the export function (equation 3.66) and the consumption function (equation 3.63) into the national income identity ( $Y_t = C_p + C_g + dK + X - Z$ ) yields a target value for output under the RMSM. Hence;

3.68

$$dY_t = 1/\alpha^{-1} - s - \mu [(s + \mu)Y_{t-1} + (1 - s)T - C_g - (\delta - \beta)e$$

The RMSM has two target variables: income and international reserves ( $dY_t$  and  $e_t dR$ ) and three policy instruments: government consumption, taxes and foreign savings ( $C_g$ ,  $T$  and  $dS_F$ ). Therefore, using the instrument variables, desired values for the output and international reserves can be set. Via foreign savings and budgetary decisions both output and the level of international reserves can be determined. The authorities can influence the flow of foreign savings, the rate of taxation and government consumption to determine income and international reserves. While, the exchange rate also serves as an additional policy instrument through its expenditure-switching effect. At an operational level, the model allows projections of foreign aid and borrowing, of which the World Bank is one source. The RMSM is a mix of accounting identities with additional behavioural equations, which links the national accounts with the balance of payments. The emphasis is on projecting financing mechanisms to close the savings and foreign exchange gaps. However, the RMSM has no place for the determination of prices, which triggered the merging with the IMF's FP.

### 3.2.2 The Merged Model of FP and RMSM

For Khan *et al.* (1990) the motivation for the merging of the FP and RMSM models, which support the lending activities of the IMF and the World Bank, is "because of the potential operational relevance – a starting point for the design of more realistic developing country models that deal with adjustment and growth" (p. 156). It is surprising to note that there is little written material on the formal models of the two institutions, which sharply contrasts with the enormous interest the subject matter attracted over the last three decades. For those who endeavoured to merge the two models the motivation rests on the premises that: 1) the models are complementary and can be put together to formulate a general framework for linking the external sector with the real sectors of an economy; and 2) the task is straightforward as the FP focuses on monetary

variables and the RMSM on real variables. As shown above, the RMSM is a two-gap model in which the level of foreign exchange that can be financed determines the potential level of output. It takes the price level as exogenous. On the other hand, FP is a model, which focuses on changes in the balance of payments and the level of nominal income. Therefore, the attraction to merge the two models stems for a mathematical necessity to close the FP by output variable as determined in the RMSM, and to close the RMSM with prices as determined in the FP framework.

Khan and Montiel (1989) attempt to merge the IMF's FP framework with a model that formulates the expansion of capacity as a linear function of real investment. This model is similar to the basic Harrod-Domar function specified above ( $d\bar{y}_t = \alpha_0 + \alpha_1 dK$ ). The constant  $\alpha_0$  captures the effects of autonomous increases in output, and  $\alpha_1$ , the coefficient on investment, is the marginal product of capital. Under the assumption of capacity as a linear function of real investment, the merged models begins by specifying equation 2.1 in Chapter 2, that is the private sector's budget constraint, as an expression of investment by substituting the consumption function (equation 3.63);

2.1a

$$Y_p - C_p - T_d - IP_{pf} - dK_p = dM + dB_g + dFA_p - dDC_p - dB_{fp}$$

$$dK_p = s(Y_{t-1} + dY_t - T_d) - IP_{pf} - dM - dB_g - dFA_p + dDC_p + dB_{fp}$$

Similarly, equation 2.2 in Chapter 2, that is the government's budget constraint, can also be specified as an expression of investment;

2.2b

$$Y_g - C_g - dK_g - TR_{gp} - IP_{gf} = dFA_g - dDC_g - dB_{pg} - dB_{fg}$$

$$dK_g = Y_g - C_g - TR_{gp} - IP_{gf} - dFA_g + dDC_g + dB_{pg} + dB_{fg}$$

Khan *et al.* (1990) assume that the public sector's income ( $Y_g$ ) comes only from taxes and its expenditure consists of consumption ( $C_g$ ), and "[I]t does not engage in any investment" (p. 157). Therefore, aggregate investment ( $dK_p + dK_g$ ) is given by;

3.69

$$dK = s(Y_{tgp} - T) + (T - C_g) - TR_{gp} - IP - (dM + dFA - dDC) + dB_{pg} + dB_{fg} + B_{pg} + dB_{fp}$$

From the RMSM we have the output-ICOR relationship where investment is now deflated by the aggregate price level.

3.70

$$d\bar{y}_t = \alpha^{-1} dK / P_{t-1} + dP$$

Where price is given by equation 2.23 in Chapter 2, substituting for the demand for money equation (equation 2.19) and equation 3.69 into 3.70 yields;<sup>4</sup>

3.71

$$d\bar{y}_t = \alpha^{-1} [(s - v^{-1}) dY_t + (1 - s)T - C_g + sY_{t-1} - TR_{gp} - IP - dFA + dDC] / P_{t-1} + dP$$

If, for simplicity, the term  $(1 - s)T - C_g + sY_{t-1} - TR_{gp} - IP - dFA + dDC$ , that is the "autonomous" part, is denoted by  $\pi$  and substituting real GDP for nominal GDP (i.e.  $Y_t = P_t \bar{y}_t$  or  $dY_t = dP_t \bar{y}_{t-1} + P_{t-1} d\bar{y}_t$ ) into Equation 3.71 and multiplying both sides by the current price level yields the following equation for the determination of real GDP;

3.72

$$d\bar{y}_t = dP_t \bar{y}_{t-1} (s - v^{-1}) + \pi / \alpha^{-1} - (s - v^{-1})$$

Solving the above equation for price, after substituting equation 2.34 for  $dP_t$  gives;

3.73

$$dP_d = [(d\bar{y}_t - \pi) \alpha^{-1} - (s - v^{-1}) / (s - v^{-1}) \bar{y}_{t-1} (1 - \theta)] - \theta deP_t$$

Finally, substituting 2.34 (the price equation) into real GDP ( $dY_t = dP_t \bar{y}_{t-1} + P_{t-1} d\bar{y}_t$ ), then into 2.19, then both 2.19 and 2.14 into the equilibrium condition for the monetary sector, yields the following equation for the determination of the balance of payments;

3.74

$$e_d dR = [(1 - \theta) dP_d \bar{y}_{t-1} + \theta deP_t \bar{y}_{t-1} + P_{t-1} d\bar{y}_t - dDC] v^{-1}$$

The merged model has instrument variables: taxes, government consumption, the level of domestic credit, and the exchange rate ( $T$  or  $C_g$ ,  $dDC_p$ ,  $dDC_g$ , and  $de$ ) and target variables: income, prices and the level of reserves ( $d\bar{y}_t$ ,  $dP_d$ , and  $dR$ ). The model can be used for “adjustment with growth” policy formulation “given chosen values for the target variables, two of the policy instruments can be chosen arbitrarily and the model will then determine values for the endogenous variables and the three remaining policy instruments. This is the model’s “programming” mode, which is “very transparent and thus easily understood. They also require very little information behaviour and are easy to apply” (Khan *et al.*, 1990).

How the IMF’s moves towards adjustment by model extension are to be fruitful, however, depends upon whether a angle is taken that is forward-looking from the original model of FP based on the Polak (1957) model. The merged model remains concerned

with the short run, with correcting the balance of payments through a squeeze on domestic credit creation. In his reply to the “marrying” of the two models, Polak (1990) argues that the attempt, firstly, “incapacitates each from doing its own job”, secondly “the simplicity that accounted for part of attraction of the two models is lost in their merger” (p. 184) and finally apart from intellectual curiosity “it adds little to our knowledge on the crucial issues of growth-oriented adjustment” (p. 186).

Polak (1997), in reviewing the place of his model after forty years, remains unconvinced about the worth of general, universally applicable models that merely seek to provide a framework within which guesswork can be employed. He is also doubtful whether his original model can be extended over time or to other policy objectives other than through reiteration of speculation concerning macroeconomic estimates. Polak argues for retaining his original model by emphasising dependence upon a constant income velocity of money, little requirement for data, and simplicity of the model, but also stresses the limitations of the approach, rendering it inappropriate for economies in transition for example. Similarly, the *Development Macroeconomics* text of Agénor and Montiel (1996), does not give attention to the merged model FP, mainly in view of its irrelevance.<sup>5</sup>

Sadly, the “marriage” between the IMF and the World Bank on an increasingly sophisticated macroeconomic modelling remains backward-looking. The outcome of the merged model is that stabilisation has been designed around a zero growth rate or an unstable growth path. The policy implications of the merged model are the same as the standard FP framework. In the short run ceilings on the level of domestic credit and devaluation will stabilise inflation and the balance of payments. From this policy exercise, however, it is not clear where and how the growth features. The merged model’s instrument and policy variables as well as its policy conclusions are the same as that of FP, which means that the short run stabilisation content of the model is still dominant with no growth dynamics provided.<sup>6</sup> In a critical assessment of the merged model described in Khan and Montiel (1989), Fine and Hailu (2002), point out that setting  $\alpha_0$  greater than zero makes steady-state long run growth impossible.

The short run and pessimistic nature of the model can be demonstrated by the following example. From equation 3.66, investment can be stated as follows:

3.74

$$dK = s(Y_t - T) - \mu Y_t + (T - C_g) - X$$

Here it is clear that steady-state balanced growth is possible only when  $T$ ,  $C_g$ , and  $X$  are proportional to income. A one time period short run change in these variables above trend growth will not have significant impact on growth. Where  $w$  is the warranted growth rate, the long run outcome can be demonstrated by;

3.75

$$w = d\bar{y}_t / \bar{y}_t = \alpha_0 + \alpha_1 s + T(1 - \alpha_1 s) - C_g - X$$

The long run outcome will be that savings will be transformed into real investment, while government expenditure and exports make no contribution to growth. The assumption that  $\alpha_0$  is equal to zero is critical to obtain steady-state balanced growth, where the growth rate will approach the Harrod-Domar warranted growth rate  $[\alpha_1 dK / \bar{y}_t (\alpha_1 s)]$ , because:  $[d\bar{y}_t / \bar{y}_t = \alpha_0 / \bar{y}_t + \alpha_1 dK / \bar{y}_t]$ . The assumption that  $\alpha_0$  is greater than zero makes the model heavily skewed towards the short-term precluding long-term stable growth. The model does not have a long run steady-state solution as growth from increased exports and other exogenous factors are excluded. Even if the model is corrected for steady-state balanced growth, it turned out to be unstable and unsuitable for analysing long run adjustment issues. This is mainly due to the application of a discrete and not a continuous time, which is in effect examining a one time period change in variables. This raises the question of the distinctions as well as the definitions of what the short run and long run are. Essentially a short-run model it does not identify the sources and causes of growth, the long-run is damaged by the policy implications attached to the model as well as by retaining the restrictive assumption of the FP model. For instance, an



increase in output, including exports, will only provide temporary relief to the balance of payments since the rise in income will eventually increase the demand for higher imports. For this result to hold, the economy must be restricted, where no extra investment and capacity from the increased output are added. There is also no place for accommodating the rise in savings from the output expansion, nor is there analysis of any dynamic economies of scale and scope.

It is remarkable to see the logic of the merged model as the short run inevitably taking care of the long run – a kind of “pennies and pounds philosophy” applied to short run balance of payments stability leading to long run growth (Fine and Hailu, 2002). This approach is surprising given the critique of stabilisation has always highlighted the harmful effects of short-term deflationary policies on output and public investment, the latter representing a key link to future output expansion. The search for long-term supply-side measures fails to take shape through the merger of the FP and RMSM, precisely because the macroeconomics attached to the merged model, is based upon the most tenuous of analytical foundations to withstand even the briefest critical examination. The merger fails mainly because of its obsession with monetary variables; its dependence on market perfection and full employment as an organising concept, the artificial division between the short and long run; and the equally sharp and artificial division between exogenous and endogenous factors.

The fact that the merger has had little reception among practitioners in the field shows that it falls short of addressing the problems of development and growth. The IMF’s another attempt on supply-side economics relied on mainstream economic analysis of financial and trade liberalisation, and privatisation, which are extensively discussed elsewhere in the literature. For the purpose of this thesis, the following will provide a critical review of some of these policies. The purpose is not to provide a detailed discussion, but to show how the IMF responded to the critique of FP by drawing on mainstream supply-side economics.

### 3.3 Financial Liberalisation

It is widely recognised that the financial sector and particularly financial intermediation is crucial to development. This aspect has been captured by early literature, which argued the importance of financial sector development for industrialisation and growth (Goldsmith, 1966 and Cameron, 1972). The financial sector contributes to capital accumulation through mediating between savers and investors. The key benefits are: 1) transaction costs of matching savers with investors is reduced; 2) intermediation creates liquidity by borrowing short-term and lending long-term; 3) intermediation minimises the risk related lending to investment via reducing information costs; 4) diversification of lending means loss from one lending is compensated by another; 5) large investment projects can be financed with relatively few savings; and 6) investment is directed in the most productive sector of the economy (for review of the literature see Gibson and Tsakalotos, 1994 and Agénor and Montiel, 1996).<sup>7</sup>

The primary objective of supply-side policies of the IMF is to improve the overall process of financial intermediation by deregulating markets. The main instrument of reform is the nominal rate of interest, normally accompanied by measures to raise overall credit available to the private sector, for example through the reduction in bank reserve requirements and ceilings on the borrowing capacity of the public sector. The basis for financial liberalisation comes from the argument that when developing countries face an inter-temporal budget deficits, they resort to inflation tax and at the same time reduce the cost of interest through financial repression. Repressed interest rates, however, do not reflect the true cost of borrowing and lead to low levels of resource mobilisation. Under repressed interest rates savers prefer to hold real rather than financial assets, or to engage in unproductive investments or resort to capital flight (see IMF, 1987). The argument for interest rate adjustment in the financial sector draws on the conceptual foundations laid by the “financial repression models” of McKinnon (1973) and Shaw (1973); in essence, these models suggest that allowing real rates of interest to rise to their market clearing level induces higher savings and investment, both through raising the average efficiency of investment and by enabling rationing of low-yield investment projects.

The underlying assumption of the mainstream approach, on which the IMF heavily relies, is that the financial system is taken as a neutral intermediary between savers and investors. The function of the financial sector is the collection of savings and their allocation for investment. The key assumptions of this approach include a perfectly competitive market; full employment of factors of production at all times; and these factors of production are paid according to their marginal productivity; the supply of savings is determined by the inter-temporal preference of individual economic agents as well as the level of the real interest rate; the level of investment is also determined by marginal productivity of capital and the interest rate; and there is full information available to savers and entrepreneurs on the viability of their investment.

The benefits of financial intermediation take place through banks as well as equity markets such as stock exchange, depending on how developed the country is. More developed economies use equity markets more than less developed economies. The financial liberalisation thesis, however, focuses mainly on commercial banks as other forms of financial intermediation are small in many developing countries. Bond markets are small and the role of development banks is minimal (Fry, 1997). Existing equity markets such as stock exchanges are not instrumental in mobilising funds for investment and simply serve as casinos (Singh, 1997). The typical programme of financial liberalisation involves two main components. First, there is an attempt to allow interest rates to be determined by the market. Thus control on both deposit and lending rates are abolished or lowered. Second, liberalisation involves reducing quantitative controls in an attempt to allow financial intermediaries greater control over the use of their liabilities (subject to certain minimum controls maintained for prudential supervision). Liberalisation is seen as a reversal of "repression" that taxed and distorted the sector through interest rate controls and directed credit allocation programmes (McKinnon, 1989 and Fry, 1980 and 1997).

Repression of the financial sector has become the focus as many countries exhibited negative real interest rates, which was the direct result of controlling nominal

interest rates at a low level. The justification for compulsory credit allocation is to finance priority areas identified as key sector for industrialisation and growth. Credit allocation also means imposing certain regulations on the financial sector. These include lending requirements, loans to preferred areas on preferential interest rates, refinancing schemes, and credit guarantees. There are plenty of cases where governments own commercial and development banks enabling them to disburse loans on a preferential basis. Advocates of financial liberalisation argue that in the face of financial control the sector will be inefficient. First, repression will result in proliferation of informal or curb markets. These markets may serve a positive purpose, but are outside of the formal regulatory body. Second, repression makes financial assets, especially bank deposits unattractive and leads to low level of financial flows into the banking system. This in turn means low level of financial intermediation, which would otherwise lead to higher investment and growth (World Bank, 1989b).

The working of the model is simple: savings are positively related to the rate of interest as well as income, while investment is inversely related to it. The higher the rate of interest the higher the level of savings and the lower the level of investment. To be consistent with equilibrium, there is a unique rate of interest that equates the demand for savings and investment. In a typical market-based system, financial institutions allocate savings at this equilibrium rate to satisfy the demand for investment, at the same time allowing for their profit as a spread between the lending and saving rates. Financial repression or government intervention that puts ceilings on the interest rate creates excess demand for investment leading to rationing of available funds. In other words the market is distorted and the actual interest rate is below the equilibrium rate. The objective of IMF financial liberalisation policies is, therefore, to remove this distortion and restore equilibrium. Hence, higher savings will satisfy the demand for investment and this in turn will bring about market- and investment-driven development and growth. Projected at the macroeconomic level, the policy objective is increasing the equilibrium level of savings or the ratio of savings to national income (see Stiglitz, 1989 and Arestis and Demetriades, 1999).

The theory of financial liberalisation commonly referred to as the McKinnon-Shaw Hypothesis, sets out the relationships among investment, real interest rate, savings and income. Equations 3.76, 3.77 and 3.78 show the formal relationships, where  $I$  is investment,  $r$  is the rate of interest,  $S$  is savings, and  $Y$  is national income,  $M$  is money,  $P$  is price (see McKinnon, 1973; Shaw, 1973 and Fry, 1982).

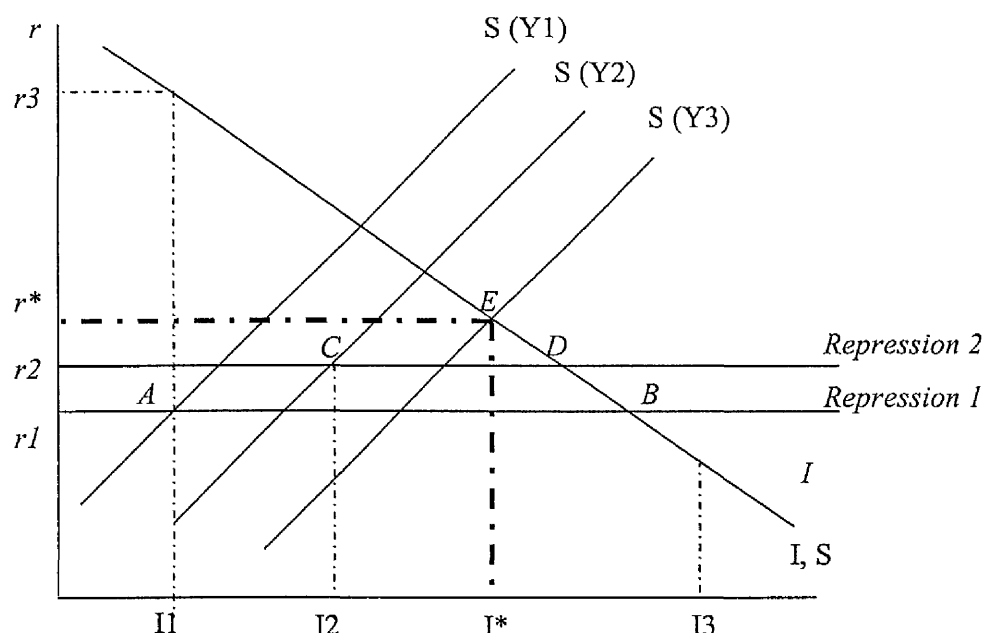
$$3.76 \quad I = I(r) \text{ where, } \partial I / \partial r < 0$$

$$3.77 \quad S = S(r \text{ and } Y) \text{ where, } \partial S / \partial r > 0 \text{ and } \partial S / \partial Y > 0$$

$$3.78 \quad M/P = f(Y, I/Y, r^*) \text{ where } \partial M/P / \partial I/Y > 0 \text{ and } \partial I/Y / \partial r^* > 0$$

The above relationship is best illustrated using Figure 3.1. At a level of income ( $Y_3$ ) if real interest rates are market determined the equilibrium in the financial sector will be at point E where the interest rate is  $r^*$  and the level of investment is  $I^*$ . If the government intervenes in the market and introduces a ceiling on nominal deposit interest rates (Repression 1), real interest rate will be  $r_1$ , and  $I_1$  level of savings (or investment) will be forthcoming at a level of income ( $Y_1$ ). The financial institutions will charge  $r_3$  on their lending and their profit margin is the difference between the lending and the deposit rates ( $r_3 - r_1$ ), which they will use for non-price competition such as opening new branches and improving services. Figure 3.1 also shows the outcome if lending rates are also repressed. At Repression 1, the lending rate is fixed at  $r_2$  and savings will be at  $I_1$ , leaving the demand for savings (AB) unsatisfied. Such intervention is rationing of available savings. Some profitable investment projects will not have access to credit both because they are not identified as priority areas and also because they tend to be high risk investments. Therefore, the impact of ceiling on the lending rate is to prevent credit from being disbursed to high risk but high profitability areas and encourages lending to low-yielding investments.

Figure 3.1 – Model of the McKinnon-Shaw Hypothesis



The case made for financial liberalisation can also be illustrated using Figure 3.1. If the government decides to ease the repression and fixes the interest rate  $r_2$  (Repression 2), savings will be at  $I_2$  as high-yielding investment also raises income to  $Y_2$ . At the new level of interest rate the unsatisfied demand for investment is reduced to  $CD$ . In this mainstream comparative static model, policy makers are presented with the clear option: either to continue interest rate ceilings or liberalise the financial sector to achieve high savings and increased investment in profitable projects. Liberalisation of interest rates is also followed by privatisation of state owned banks to increase competition and bring about efficiency via decreases in interest spreads (Fry, 1988 and McKinnon, 1989).

Financial liberalisation has been taken up by the Washington consensus as far as a rise in deposit rate increases the supply of credit for working capital as well as fixed capital formation. In a more formalised way it has been argued that financial liberalisation attracts more savings not only from those who previously preferred to hold real assets but also those invested in low-yielding projects. The latter group will be attracted to savings as the deposit rate increases due to liberalisation. Therefore, higher

savings in the aggregate economy allows increased investment and growth (Galbis, 1977). The use of the interest rate as a stabilisation policy tool is preferred compared to the traditional direct reduction in the money supply through credit squeeze as shown in the financial programming model. In the latter case output falls because of the low interest rate elasticity of money demand. Credit squeeze or an increase in the reserve requirement ratio reduces the money supply and reduces the availability of loans in the financial sector (Porter and Ranney, 1982). Financial liberalisation, therefore, is a counter movement to the fall in loanable funds, which is often followed by opening domestic financial sector to foreign investors as well as liberalising the capital account. Inflows of capital increase in a liberalising economy for two reasons. First, the new deposit rate will be above the world rate and marginal productivity of capital will be higher (Bacchetta, 1992). The dilemma is increased capital inflows will undermine the stabilisation objective of controlling inflation. For the policy maker the message is financial flows must be anticipated when designing stabilisation programmes (Kapur, 1983 and Mathieson, 1980).

So to increase output or maintain it at same level, the initial stabilisation can increase the deposit rate and the money supply at the same time, as long as the demand for money does not outstrip its supply. The rise in the interest rate will dampen the inflationary pressure brought about by the monetary expansion. However, a typical stabilisation programme also involves exchange rate policy. Devaluation signals a capital outflow as agents expect further devaluation. The increase in the deposit rate counters such outflows, assuming that the impact of devaluation on import prices is not significant to change output (Kapur, 1983). Such assumptions are highly restrictive as imports are demand inelastic in most developing countries. Another avenue is that the money supply can be restrained and the currency can be overvalued to control inflation and reverse expectation of further devaluation, in effect signalling overvaluation, to maintain capital inflows. This would mean deposit rates should not rise significantly above the necessary level to eliminate credit rationing. Such stabilisation will maintain output increases through availability of loanable funds (Mathieson, 1980).

What is clear from the relationship between financial liberalisation and growth is that the addition of the exchange rate introduces a policy dilemma as devaluation affects the price level and capital inflows. The response to such policy conundrum has been to argue for sequencing and timing of financial liberalisation. Specifically, the emphasis has been on the relative merits of liberalising the capital account first and then the current account or vice versa (see McKinnon, 1973, 1991 and Choksi and Papageorgiou, 1986). The popular argument is for liberalising the current account first, on the grounds of avoiding real exchange rate appreciation that follows capital inflow (see Edwards, 1992). On the issues of gradual versus rapid reform the experience of China and East European countries particularly Russia is instructive. China managed a gradual reform due to the strength of the government and the rapid growth in agricultural income, whereas in Russia rapid liberalisation led to two-tier pricing strategy and a squeeze in the state sector and fall in output (McKinnon, 1993 and Stiglitz, 2002). The idea is to seek an optimal sequencing of financial liberalisation, capital account liberalisation, trade liberalisation and domestic real sector liberalisation.

The search for optimal sequencing path is motivated by the need to reduce the unwanted effects of liberalisation. As discussed above, devaluation implies capital outflows, which must be prevented by higher interest rates. If controls on the capital account remain the need for higher interest rates would not have risen. The implication is that financial liberalisation should be carried out after real sector liberalisation and before capital account liberalisation. It is sensible to liberalise the real sector first as the model requires undistorted prices. Real sector liberalisation takes the form of removing domestic price controls, removal of subsidies and privatisation. However, sequencing of the other reforms is less clear. If the financial sector were liberalised before trade liberalisation, credit would flow to the tradable sector only because the sector is profitable due to trade barriers. If trade liberalisation is carried out first, then the tradable sector will not be able to obtain investable funds from the repressed financial sector. Another conundrum is related to fiscal policy. Under repressed financial regime governments raise revenue through taxing and direct control of the financial sector. Liberalisation means loss of revenue in the short run until the increase in investment and



output increase tax revenues. In the meantime tax reforms or alternative revenue; usually foreign aid is necessary (Gibson and Tsakalotos, 1994).

### 3.3.1 Financial Liberalisation Contested

The link between financial liberalisation and development as described above is questionable. Financial transactions do not conform to the mainstream analysis and banking crises are recurrent (Nissanke, 1991; Goldstein and Turner, 1996; Adams, *et al.*, 2000; and Arestis, Nissanke, and Stein, 2003). Early evidence indicates that there is only a weak interest elasticity of aggregate domestic savings for both developed and developing countries (Giovannini 1983). The critique of financial liberalisation comes both on the theoretical foundation and the practice or the experience on the ground. The critique focuses on the assumption of always equilibrating competitive market, which is the central thesis of neo-classical economics (Singh 1997). Financial liberalisation along the McKinnon-Shaw line has led to banking crises precisely because of the weak foundations of the theory, which fails to take account of institutional requirements for building and transforming financial systems for economic development. In the context of SSA, Aryeetey and Nissanke (1998) find that, unlike the “financial repression hypothesis”, personal relations, and social cohesion at community level influence perception of risk. This is consistent with other findings which underline that a large proportion of credit transactions take place within the village and between traditional networks, which minimises transaction costs (Udrey, 1993). Analysis of social structures and institutions is necessary to understand financial transactions beyond simple market equilibrium.

Within the Keynesian tradition it has been argued that savings and investment do not always equate and a rise in the former does not necessarily imply increased investment. Within the alternative paradigm, it is argued that interest rates are determined in the money market and investment very much depends on expectations of future demand. In the financial liberalisation model prices clear instantaneously and buyers and

sellers meet for transaction purposes only. Such assumptions are devoid of institutional and historical contexts in which financial market operate. The market reflects the actions of banks, consumers, savers, investors, trade unions, government departments, etc. Relationships and trust among these institutions is what reduces information costs and uncertainty (Soskice, 1991 and Patrick, 1996). As the post-Keynesian critique pointed out, the role of effective demand in determining investment does not feature in the financial liberalisation model. Effective demand is determined by social conflicts and the resulting income distribution.

First, a rise in deposit rates raises the marginal propensity to save (MPC). As the MPC is higher for capital the overall effect is a fall in effective demand. The fall in demand is not offset by a rise in investment. The fall in output further depresses investment and the rate of profit. The effect of liberalisation is worse on output than the case under financial repression. In the long-term high lending rates discourage investment and mark-up prices increase, which further deflates demand as real wages fall (Burkett and Dutt, 1991). Second, interest rate increases also overvalue the exchange rate due to increased demand for savings denominated in the currency of the liberalised economy, which affects export performance. Third, banks may loose out as the interest rate spread is reduced. The margin for banks is the difference between the lending and the deposit rate. Often banks lend long-term on fixed interest rate and pay interest on short-term deposits, what is called maturity transformation. If deposit rates rise due to liberalisation the banks margin declines further depressing effective demand. Fourth, if liberalisation removes taxes on the financial sector government deficit is likely to increase. Liberalisation worsens the deficit as government debt repayments also increase following interest rate rises. Effective demand is affected through loss of revenue (Dutt, 1991). Fifth, market clearing interest rates should not necessarily be positive or very high. Experience has shown in Latin America that investment is not forthcoming in the face of uncertainty and low expectations. In addition, even under the repressed rate, which may be very low, financial savings may be higher as households opt for liquidity preference than holding real assets under the face of uncertainty and high inflation. What happens under liberalisation is what is commonly known as “upward financial repression”

(Beckerman, 1988). Either banks will hold excess liquidity or bad loans. The latter is the result of excess supply of loanable funds implying the economy is short of profitable investment projects.

As the neo-structuralist critique points out, financial liberalisation reduces the total supply of credit in the economy through increasing bank deposits that are subject to reserve requirements. As savings that were taking place outside of the banking system, either in unproductive assets such as precious metals or antiques or in the informal or curb market, are incorporated into the formal sector, reserve requirements reduce the total available credit (Taylor, 1983).<sup>8</sup> The effect of liberalisation may also be to shift currency holdings into time deposits, which will increase total credit availability. The effect on the informal sector is much more significant than the transformation of unproductive assets and currency into bank deposits (van Wijnbergen, 1983a and 1983b). The implication of the fall in total credit is decline in output and increase in prices, which makes financial liberalisation stagflationary.

At a microeconomic level the financial sector does not work as the typical mainstream analysis suggests. Particularly equilibrium is not instantaneous during liberalisation. Even under a competitive financial market where loan markets reflect true social costs credit rationing may persist (Rothschild and Stiglitz, 1976 and Stiglitz and Weiss, 1981). More fundamentally, the neo-classical assumption of the auctioneer and the absence of institutions are major deficiencies of the model. This is to do with the existence of asymmetry of information leading to moral hazard and adverse selection (Stiglitz, 1989 and 1993). Lenders do not have full information on the profitability of their borrowers and the projects they are funding. The reason for not having perfect information is the sheer size of their loan portfolio and the cost of finding out borrowers profitability. One instrument of identifying profitable projects is to increase interest rates. However, borrowers with less risky projects prefer not to borrow at high levels of interest given the low level of return. Therefore, the loan market will be dominated by risky projects changing the portfolio of banks. The banks response will be to ration credit,

anathema to the liberalisation school. The implication is that liberalisation will not reverse credit rationing.

A related concept is also that a stable financial sector is a public good. A failure of one institution spreads across sectors, as the role of financial intermediation is crucial to the economic system (Diaz-Alejandro, 1985). Another issue is the presence of moral hazard. If financial institutions take it the government will rescue them, they tend to engage in risky lending. Before instability is spread throughout the sector the government must intervene to correct the market failure associated, for example, with imperfect information. As a public good, financial stability must be maintained through appropriate supervision. The market alone cannot guarantee efficient allocation in the face of market failures such as economies of scale and economies of scope. Liberalisation of interest rates and privatisation of state-owned banks might not necessarily result in allocative efficiency. The result may be a much more concentrated firm structure. Banks cannot be small and at the same time diversify their products. If they opt to diversify they lose the economies of scale and scope associated with specialisation: the optimal bank size remains ambiguous (Gibson and Tsakalotos, 1994).

What does the empirical evidence show? Various studies have highlighted the negative effects of financial liberalisation. Latin American countries have had a bad experience and the liberalisation process was aborted in many cases (Capiro *et al.*, 1994). Financial liberalisation was followed by increased demand for credit by the private sector, which was not matched by increased savings. As a result loan rates went up, households continued financing expenditure on consumer goods out of savings, while firms engaged in speculative investment knowing that the government would bail out the banks. Most lending practices after liberalisation focused on short-term lending to investors often located in the urban sector, leaving out the rural sector (Stiglitz and Uy 1996 and Griffith-Jones and Cailloux 1999).

Financial liberalisation increased volatility and crises in the sector (Akyuz and Cornford, 1999). The banks also increased interest rates further to compensate for

increased risk. While domestic savings did not increase significantly, foreign savings rose and the economies became dependent on international capital and the associated volatility (see Arestis and Demetriades, 1997). As the experience of Chile demonstrated the financial sector is characterised by market failures in the credit market under the absence of effective supervision (Diaz-Alejandro, 1985 and Araya-Gomez, 1990). The failure of financial liberalisation is also due to lack of coordination among other macroeconomic policies as was the case in Turkey (Çapoglu, 1990). The experience of Asia is rather different. The liberalisation process was managed by government intervention. The government influenced interest rates, managed credit allocations, kept real interest rates positive, and coordinated the flow of credit to the export-sector (Amsden and Euh, 1993 and Wade, 1990).

The experience of Latin America and Asia gave rise the revision of the financial liberalisation thesis. The review was not a fundamental shift from the theoretical underpinning but focuses on implementation. The failure of liberalisation has been blamed on wrong sequencing and attention focused on liberalising the real sector first (McKinnon, 1991 and 1993). The simultaneous liberalisation of sectors will inevitably conflict one another. For instance, high interest rate may cause the exchange rate to appreciate and exports to fall (Sachs, 1988).

Financial repression that imposes lending rate ceilings may also lead banks to manage their deposit liabilities effectively. Banks may find that the only way to increase profit is to increase the volume of credit and deposits. Therefore the repression actually may bring about increased deposits through expansion of banking services as the case of South Korea aptly demonstrates (Demetriades and Luintel, 1996 and Arestis and Demetriades, 1997). Financial liberalisation also made emerging economies more susceptible to both currency and banking crises by allowing more liquidity, which finds its way into non-productive and speculative projects, thereby increasing the chance for borrower default. The institutional aspect of financial transactions is completely ignored. For instance, the approach also fails to take account of consumption bubbles, speculative behaviour, which in some cases led to major financial crises (see Diaz-Alejandro, 1985,

and Stiglitz, 1989). The theoretical foundations of financial liberalisation are found to be weak and even under strong regulatory and supervisory capacity it may result in financial crisis (Arestis and Demetriades, 1999). Strong institutions only abate the severity of the crisis but fundamentally what brings about crisis is the liberalisation itself.

In South Korea, premature liberalisation that did not take account of weaknesses in institutions resulted in crisis. Financial liberalisation where excess liquidity exits and when the real sector cannot absorb liquidity leads to speculative investment (Demetriades and Fattouh, 1999). The crisis in Thailand was also the result of financial liberalisation in the face of weak institutions (Alba, *et al.*, 1999). Often liberalisation of both the external and internal markets results in financial flows both to the productive and speculative sectors. However, the mismatch between the slow growths of the real sector compared to the financial sector diverts capital to the speculative sector, which in turn results in banking and currency crisis. The outflow of international capital and the chance of a crisis occurring in response to changes in short-term loans are greater after financial liberalisation (Weller, 2001).

As witnessed in Madagascar in the 1990s, credit flowing to the private sector after financial liberalisation was falling although the banking system was on an excess liquidity position. The reasons for falling credits; first, is associated with austere monetary policy introduced as anti-inflationary measure. Monetary policy resulted in higher interest rates and increases in reserve requirements. Second, financial liberalisation did not tackle the fundamental issues concerning the risk faced by banks as well as the increase in non-performing loans. This was mainly related to asymmetric information and adverse selection (Gautier, 1999). Financial liberalisation in Malawi led to the removal of credit ceilings and interest rate controls and opened the banking system to new competition. The results show that financial liberalisation has significantly reduced repression with respect to the depth of the financial system, reduction in monopoly power, increase in savings mobilisation and relocation of credit to the neglected sectors. However, due to macroeconomic instability during the adjustment period, elements of financial repression remain as reflected by a fall in real interest rates,

increase in intermediation margins and a fall in the relative share of loans and advances in total assets (Mlachila and Chirwa, 2002). Financial sector liberalisation measures implemented in the early 1990s in Zambia led to a permanent shift in the demand for narrow money, which undermined the efficacy of money-based stabilisation efforts (Adam, 1999). Liberalisation fails to capture the particularities of community based indigenous networks and traditional kinship relationships, which provide insurance to private agents and the significance of grassroots financial transactions (Aryeetey and Nissanke, 1998).

There is a voluminous econometric work purporting to address the link between economic growth and financial liberalisation by examining interest rate elasticities in saving, investment and growth equations. Faster rates of growth, high physical capital accumulation has been associated with financial development (see World Bank, 1989a; King and Levine, 1993 and Fry, 1997). However, it is known that econometrics evidence suffers from inappropriateness of using average data for cross-country studies. Overall the empirical evidence is very mixed, mainly explained by data problems. Savings data in most developing countries suffer from measurement errors and there is evidence of constant updating. There are also methodological problems related to using reduced form equations for econometric testing. The equations may not be correctly specified and may omit relevant variables (Evans, 1995b and Arestis and Demetriades, 1997). Improved governance is more important to attract less volatile capital inflows. The success of East Asian financial liberalisation is attributed to state intervention and gradual liberalisation in response to structural problems such as supervisory capacity. Contrary to the evidence in Latin America, where the evidence shows that increased financial flows into developing countries have caused consumption volatility, which is the preferred measure of welfare improvements (Vos, 1994). The theory that developing countries transfer their consumption risk by opening up their economies through increased savings and technological transfer is suspect. As Prasad *et al.* (2003, p. 5) note:

“a systematic examination of the evidence suggests that it is difficult to establish a strong causal relationship. In other words, if financial integration has a positive effect on growth, there is as yet no clear and robust empirical proof that the effect

is quantitatively significant...financial integration should be approached cautiously, with good institutions and macroeconomic framework viewed as important.”

### 3.4 Trade Liberalisation

Another core component of IMF supply-side adjustment programmes is trade liberalisation. The removal of disincentives to imports and exports is meant to restore the external balance, as well as on grounds of efficiency and welfare gains. Associated with the idea of trade liberalisation is the reinstatement of classical theory, which claims that free trade is the best regime for the whole world. The central facet of this theoretical approach is the claim that trading partners always gain from unfettered transactions and trade between nations is the same as trade within nations. The theoretical ballast is provided by comparative advantage and comparative cost arguments (Helpman and Krugman, 1985 and Krueger, 1998a). For instance, a country with lower costs arising from higher productivity, better technology, lower wages etc., will have guaranteed success. What is important is liberalisation and countries with generous natural resources would benefit from maintaining their higher share in exports (Ranis, 1985). This implies that high cost and low productivity economies will fail to reap the gains from trade. The argument for trade liberalisation states if two countries trade and if one of them has higher costs of production, under a fixed exchange rates system, the high cost country will have a deficit in the balance of payments. As a deficit means an outflow of money, the domestic price level will decrease. Lower prices will make the country competitive and its trade balance will improve. Under the case of a flexible exchange rate system, it is the exchange rate, which adjusts. The deficit country would see its currency depreciate, which also means the price of its exports decreases. This will make the country's exports competitive and the trade balance improves. The model under which the above interactions take place is a general equilibrium model, built upon the choices of individual agents interacting solely through the market (Dornbusch, 1974 and Krueger, 1993a, 1993b and 1998a).



Krueger (1998a) presents the following reasons why openness is good:

1. Developing countries are dependent on imported goods for their structural transformation from agriculture to industry and from household production to production for trade. In addition, these countries depend on imports for the “preponderance” of manufactured goods used domestically. Therefore, the trade regime determines the direction in which resources are allocated as well as determines the pattern of production, especially in manufacturing.
2. Growth in developing countries is heavily dependent on capital goods, which are usually imported according to comparative advantage. Most developing countries are assumed to have comparative advantage in labour-intensive production. If barriers are imposed and high cost local production substitutes for imported capital goods, it precisely means pulling resources out of labour-intensive areas (or moving away from comparative advantage). This means, “slower growth because a given fraction of national income saved implies a lower level of real investment as the prices of capital goods are higher” (ibid. p. 1515);
3. Developing countries are characterised by low per capita income and this implies markets are small beyond housing and food markets. Protecting these markets results in low-quality high-cost production beyond that warranted by comparative advantage. This is often the result of concentrated market structures and lack of competition. While, liberalisation results in low-cost production as well as market destination for foreign consumption;
4. The demand for foreign exchange grows faster than the supply of foreign exchange earned from exports. As protection attracts resources into import-substituting sectors, which are also import intensive, there will be severe shortages of foreign exchange. Persistence to increase the price of foreign exchange leads to more restrictive import licensing and exchange control as well as increased illegal activity such as smuggling;
5. The consequent authority bestowed upon bureaucrats to allocate scarce foreign exchange based on their own discretion and judgement is inefficient. The assumption of such power leads to corruption and rent-seeking; and
6. Continuous protection to preserve import substituting strategies becomes transformed into a complex set of trade regime that consumes civil service time, the opportunity cost being the development of other institutions and infrastructure.

In summary, if governments intervene and introduce trade barriers, which is transferred into higher prices, the market will not work. In other words, an overvalued exchange rate is caused by trade protection that misaligns the relative price of non-traded in terms of traded goods (Shatz and Tarr, 2002). Reversing strategies associated

with inward-looking and import-substituting policies and introducing liberalisation of trade is aimed at restoring market equilibrium and fuelling economic growth. The basis for the analysis is the hypothesis that trade liberalisation reduces anti-export bias and makes exports, especially non-traditional ones, more competitive in international markets (Bhagwati, 1988 and Bhagwati and Srinivasan, 1999). The basis for the argument against protections is that import-substituting industrialisation that consisted of high tariffs, import controls, subsidies; and exchange controls forms an anti-export bias, which results in large welfare losses (de Melo and Robinson, 1982).

Import-substituting strategies, by pulling resources into import-competing industries, result in export earnings growing less rapidly than the demand for foreign exchange and real GDP. The consequence is to impose restrictive import licensing to counter foreign exchange scarcities and resort to trade barriers. The famous example of countries that abandoned such restrictive measures and witnessed rapid growth of exports and imports are Korea, Taiwan, Hong Kong, and Singapore (Krueger, 1998a). Earlier studies that argued on the same line include Little *et al.* (1970), Balassa (1978) and Krueger (1978). The message is protection nurtures inefficiency: 1) Protectionism does not solve market and product imperfections as these are the results of domestic policy errors. The first-best policy is to use domestic policies as protection produces unnecessary rent related activities.; and 2) No need to intervene as wages are largely determined by technology and technical change because of free trade (Bhagwati and Dehejia, 1993; Bhagwati, 1994; and Robert and Tybout, 1997).

Trade liberalisation not only increases the volume of goods and services traded, but also benefits the economy through knowledge embodied in the products traded. At the same time, increased imports augment the spillover of international technical know-how (Grossman and Helpman, 1991 and Rivera-Batiz and Romer, 1991). Exposure to external competition encourages domestic firms to adopt newer and most efficient technology or to use the same technology with less waste or less x-efficiency and compete against international firms (Nishimizu and Robinson, 1984). Moreover, the removal of less efficient firms, previously able to operate inefficiently because of

protection, results in lower average costs and higher productivity. The firms that remain in the industry must adjust by expanding their scale of production, exploiting economies of scale, and reducing technical efficiency. Because domestically produced goods cannot replace imported intermediate and capital goods in developing countries, imported inputs tend to increase knowledge and improve technical efficiency. Liberalisation, therefore, has significant effects on productivity (Harrison, 1994).

Similarly, trade liberalisation improves economic performance and positively affects the poor in developing countries due to their special structural features (Buffie, 2001). The effect on the poor relies on the notion that economic growth ultimately benefit society as a whole and availability of new types of imported goods or increase in market size (Blackburn and Hung, 1996); through reductions in export taxes that help primary commodity producers; and increases in factor income depending on factor intensity of the trade sector (Winters, 2002). Trade liberalisation has impacted upon relocating decisions of industries from high trade barriers countries to more open ones. A survey of manufacturing firms in developing countries demonstrated that trade liberalisation has a positive impact on location decisions of firms (Amiti, 1998). Although the largest proportional gains are to the urban self-employed, there are significant gains in agriculture that benefit almost all categories of rural household (Blake, *et al.*, 2002)

Trade liberalisation also impacts upon the fiscal balance as revenues in most developing countries rely on trade taxes, such as export tax on a primary commodity exports. The effect of trade liberalisation on the fiscal balance depends on the nature of the trade barrier as well as the method of revenue financing. For instance, largely import tax financed fiscal balance will be unstable as imports fluctuate with the ability to import (Tanzi, 1989a). Generally, trade liberalisation measures are said to have a positive impact on revenue as they replace quantitative restrictions (QRs) by rationalised tariff structure. This is because QRs such as quotas and bans provide no revenue and stimulate rent-seeking as well as illegal transactions (Ebrill *et al.*, 2002). The positive impact on revenues works if the abolition of QRs leads to higher imports and if exchange rate changes also lead to increased exports and increased official transactions as well as

increased imports. Thus the elasticity of the demand for imports and elasticity of the supply for exports determine the outcome on the fiscal balance. Administratively the adoption of uniform tariff structures minimise tax evasion and ease the burden on tax administrators (Ebrill *et al.*, 2002). Moving farther away from trade taxes, particularly taxes on exports, which is often levied as a substitute for income tax in sectors difficult to impose such taxes, must also be accompanied by other taxes such as VAT to compensate for the fall in revenue. Empirical findings purport that trade liberalisation in most developing countries was associated with increased fiscal revenue (Ebrill *et al.*, 1999).

The argument in favour of trade liberalisation also comes from the correlation between openness and improvements in other policy areas (Krueger, 1990). This finding is supported by correlation of openness with low inflation (Romer, 1993). At the same time it has been shown that large and rapid liberalisations have been sustainable (Choksi *et al.* 1991). In the case of SSA, particularly in Nigeria and the CFA zone, it was shown that reductions in tariff rates or relaxation of quotas reduced the price of importable goods (Collier and Gunning, 1992). The resulting disequilibrium will be the emergence of excess demand for money and a deficit in the balance of payments. Restoring equilibrium, therefore, requires increases in the demand for money through devaluation and increased donor programme aid to finance the deficit until money market equilibrium is restored. The message is greater compatibility among policies including trade liberalisation is necessary (Collier and Gunning, 1992). The timing and sequencing of trade liberalisation in phases with other policy measures is also significant for its success. Timing and sequencing in phases for instance, trade liberalisation immediately after macroeconomic stabilisation sends a clear signal for credibility. Similarly, trade liberalisation well before capital account liberalisation will minimise the destabilisation associated capital movements (Falvey and Kim, 1992).

Based on the above argument for free trade a number of countries under the IMF and World Bank tutelage have liberalised their trade regime. First, liberalisation focused on elimination of export duties, and administrative and other non-quantitative barriers. Second, tax concessions and duty drawback schemes were introduced. Third,

administrative barriers such as export and import licensing were lifted. Fourth, liberalisation changed laws and regulations to encourage the flow of FDI. Fifth, export promotion and development agencies have been established. Sixth, foreign exchange retention schemes were introduced. Seventh, anti dumping tariffs were enacted. In general, the IMF encourages trade regimes that usually include the adoption of a low, uniform tariff structure which provides equal effective protection to all producers of tradable goods and the elimination of QRs such as quotas, bans, export and import licensing, and state trading monopolies. Tariffs tend to be described as preferable to quantitative restrictions, because they insulate domestic producers from world market conditions and stimulate “rent-seeking and Directly Unproductive Profit-Seeking behaviour (DUP)” as argued by Krueger (1974), Bhagwati and Srinivasan (1980) and Bhagwati (1982).

### 3.4.1 Trade Liberalisation Contested

The critique of trade liberalisation has, for most of the 1970s and 1980s, focused on market imperfections that necessitated intervention pioneered by Chamberlain (1929) and Robinson (1931). The argument challenged the traditional view of market structure as two extremes: perfect competition and pure monopoly. The critique shows that prices do not necessarily reflect social-costs as the proponents of free market advocate. In the 1980s the imperfection was related to factor markets associated with inter-sectoral wage differentials, divergence between market as well as shadow wages and sector-specific minimum wages. As the *unfair* trade school shows free trade has implications for both the developed and developing countries. Free trade depresses wages for unskilled labour in the developed world as was the case in Mexican wages bringing down US wage rates (Perot and Choate, 1993).<sup>9</sup> Under this theme free trade negatively impacts on the environment, labour standards as well as unfair trade in the sense of trade protection by the developed countries themselves through dumping and subsidies. At the theoretical level relationship between trade and growth poses a paradox for neo-classical theory

because trade liberalisation produces only limited level effects, not long-run growth effects, as predicted in neo-classical growth models (Lucas, 1988 and House, 2000).

Empirical evidence of the effect of trade liberalisation on export performance has been mixed. The staunch advocates argue that open economies grow faster (Edwards, 1993). Case studies such as Weiss (1992) on Mexican manufacturing exports, Joshi and Little (1996) on India, and Ahmed (2000) on Bangladesh have shown a positive link between trade liberalisation and export performance. On the other side of the debate works such as UNCTAD (1989), Agosin (1991), Rodrik (1992), Shafaeddin (1994), Harrison and Hanson (1999) and Thirlwall (2000) find no significant impact of trade liberalisation on export performance and showed the limits of trade liberalisation on exports and growth. A recent survey of the empirical literature by Rodríguez and Rodrik (2001) has shown that the direct link between trade liberalisation and economic growth is ambiguous, mainly due to suspect methodology and confused econometric analysis that failed to distinguish exogenous and endogenous sources of growth. Success of openness depends mainly on how the movements towards comparative advantage lead to activities that promote economic growth. Examples are the level of research and development expenditure, diversification of exports, and improving quality of products. The message is those economies that benefited from openness did so not just by dismantling trade barriers such as tariffs and QRs but through a concerted marrying of the opportunities offered by the international market with domestic investment capability. As witnessed in East Asia, China and India success was guaranteed through gradual opening of the economy to foreign products and investment and domestic institutional development. The positive relationship between open trade regimes and economic performances is seriously questioned (Sachs and Warner, 1995).

Particularly the absence of institutions and complementary policies constrain the impact of trade liberalisation. Trade liberalisation and integration of developing economies in the global market means greater exposure to external risk such as the cost of implementing World Trade Organisation (WTO) standards and requirements, which requires large economies with developed institutions. In fact, trade liberalisation is to be

seen more than changes in tariff structures but as a broad institutional and policy change. Examples are solid property rights created by tariff bindings under international trade agreements (Rodrik, 1998). Similarly, trade liberalisation has impacts beyond narrow specification of growth as is common in the literature. Trade reforms affect income distribution, poverty and the environment (see Corden, 1997). For instance, tariff reduction on exports of logs, in the absence of other substitutes, leads to excessive deforestation. It has been found that reduction in Mongolia's export tax on cashmere has led to excessive grazing of common pastures (Anderson, 2002).<sup>10</sup> Policy should focus on defining property rights appropriately and building the institutional environment. One such example is the distinction made between trade liberalisation and outward-orientation. The former can roughly be thought of as replacing QRs with tariffs, while the latter is a strategy based on the growth of domestic economic activity in response to producer incentives that closely mirror international prices. Therefore, outward-orientation necessitates policy towards developing infrastructure such as transportation and communication. Rodrik (2002, p. 3) also notes that trade liberalisation:

“goes beyond particular levels of tariffs and QRs: it sets new rules and expectations regarding *how* these policy choices are made and implemented, establishes new constraints and opportunities for economic policy more broadly, creates a new set of stake holders while disenfranchising the previous ones, and gives rise to a new philosophy (alongside a new rhetoric) on what development policy is all about.”

It is right to argue that given the small size of the market and heavy dependence on imported goods Africa needs to export for its development and increased investment (World Bank 1994 and UNCTAD, 1998, 2000). However, inconsistent macroeconomic policies and weaknesses in institutions, infrastructure, and available human resources constrain export performance. Even if macroeconomic policy is consistent and firms respond to the right incentives, the resulting productivity gains could be offset by, other developments such as declines in factor accumulation (Elbadawi, 1992; Martin, 1992; and Helleiner, 1995). The impact of trade liberalisation on export growth in developing countries varies across continents. In most countries it was found that export duties have a small detrimental effect on export growth, while relative price changes and world

income growth have the expected signs. In the case of Uganda where unilateral liberalisation of import tariffs took place, especially in agricultural commodities, the findings are: 1) the impact of multilateral liberalisation appears to be slight, albeit positive, largely because there is only a minor impact on the world prices of the agricultural commodities it exports; and 2) the principal gains actually arise from trade reforms that are essentially unilateral in nature (Santos-Paulino, 2002).

In Zimbabwe trade liberalisation that took place in the 1990s removed quantitative restrictions but left tariff rates intact. The results show that tariffs on intermediate goods have held back production in traded sectors. Thus, the nature of the trade reform taken contributed to more deindustrialisation than necessary. The results also show that there has been a trade-off with respect to the fiscal balance, which points to the revenue reducing impact of trade liberalisation (Mabugu, 2001). The argument for trade liberalisation ignores why protectionist policies were placed in the first instance. Besides a commitment to catch-up with developed countries through infant-industry development, protectionism had a defensive character. First, tariffs still make up a significant source of revenue where direct income taxes and indirect business taxes are not adequate due to low tax base and large informal unmonitored transactions, especially in the least developed economies. Second, import tariffs and exchange controls were introduced in response to balance of payment crises which resulted from falling commodity prices, falling aid flows and world recession (Santos-Paulino, 2002).

The evidence indicates that liberalisation has not been followed by a favourable response in sub-Saharan African economies. Examples from Côte d'Ivoire and Tanzania indicate that trade liberalisation alone does not create the incentives for increased agricultural production. Additional sector specific reforms are needed to ensure that world prices are transmitted to producers and that producers' ability to respond is facilitated (McKay *et al.*, 1997). There are losers from trade liberalisation, which arises from local producers being unable to compete with imported goods. The case of Zimbabwe and Zambia illustrates that infrastructural and credit support must go hand in hand with trade liberalisation (Winters, 2002). In Central American countries, where



trade liberalisation created incentives for the agricultural sector, the impact has not been associated with improved agricultural performance. The failure of agriculture to respond positively to policy changes can in part be explained by an unfavourable trend in world prices of the region's major tradable commodities (Weeks, 1999). The impact of trade liberalisation in small economies is significant. This is because small states rely on the tradable sector given the domestic low market and limited resource base to sustain domestic production and consumption. Small states are open to counter the diseconomies of small size such as the inability to diversify exports, however they also face severe risks in terms of trade changes (Armstrong and Read, 1998).

In their critical survey of the literature as well as through analyses of the microeconomic and macroeconomic effects of trade liberalisation, Ocampo and Taylor (1998) argue that the new theories of trade, which describe international markets as imperfectly competitive and focus on economies of scale and technological rents, have not influenced the design of IMF stabilisation and adjustment programmes. These models have very different policy implications from those of the neo-classical theories at the heart of trade reforms advocated in adjustment programmes. Ocampo and Taylor (1998, p. 1543) conclude that;

“good productivity performance in the Asian economies has been associated with outward-oriented, but distinctly not liberal trade regimes... Their histories show that trade and other interventions are not always harmful; indeed, at least in terms of economic performance, they can promote substantial good.”

### **3.5 Exchange Rate Policies and Expenditure-Switching**

Depreciation of the exchange rates is not only a deflationary policy as in expenditure-reduction discussed in the previous chapter, but also as an instrument for expenditure-switching via encouraging production for export. Currency depreciation, under IMF programmes is prescribed as it increases foreign demand for exports, lowers the domestic demand for imports expressed in foreign exchange, and raises the domestic demand for and supply of import substitutes. All these changes, however, depend on the

demand and supply elasticities. For instance, a country, which produces coffee, where the price is fixed internationally, cannot influence the price through depreciation. In this scenario the export demand elasticity has no role to play. The supply elasticity is what determines the outcome depending on the gestation period of the commodity, the availability of investment finance, factor mobility, and excess capacity (Bird, 1983).

For small developing countries that can sell as much as they like at the going world foreign market, price elasticity must exceed zero on the export supply side, if the supply of foreign exchange is to increase. On the import demand side, price elasticity must also exceed zero to decrease the demand for foreign exchange. Export supply and import demand together, and under the assumption that both foreign demand for exports and import supply are infinitely elastic, the Marshall-Lerner condition reports that devaluation will improve the current account given that the sum of the price elasticity of export supply and import demand exceeds one. In the case of a country, which sets prices for its exports, or if the small country assumption is relaxed, the elasticity of supply for exports must exceed unity to satisfy the supply of foreign exchange, when the rate is depreciated. If this holds, the current account will improve. However, if the supply elasticity of exports is less than unity, the demand for imports must fall significantly to improve the external account. In most developing countries it has been found that the elasticity of demand for imports is inelastic. Unless the elasticity for supply of exports exceeds unity, the impact of depreciation will be negative (Bird, 1983). The elasticities condition, however, assumes that the balance of payments is in balance, which is unlikely in most developing countries.

Export competitiveness is the key to successful supply of foreign exchange and to this, distinction must be made between the nominal and real exchange rate. Change in the former is what policy makers announce, but competitiveness requires the domestic price level to be lower than other competitors or the real exchange rate must also depreciate. Similarly, where trade liberalisation is simultaneously implemented the effective exchange rate change may be less than the nominal devaluation. The impact of currency depreciation on domestic prices is through imports. The transmission mechanism works in

such a way that import prices feed into domestic inflation. Mainly this is the result of inelastic demand for imports and the fact the developing countries cannot individually affect import prices. Reference to such scenario is a small import dependent economy. However, the extent of domestic price rises due to devaluation depends on implementation of other policies sequentially or simultaneously. If trade liberalisation removes import controls such as quantitative restrictions and tariffs, which inflate import prices, their removal lessens or offsets the impact of devaluation (Krueger, 1978).

Exchange rates devaluation or removing the parallel market premium is key to IMF supply-side adjustment programmes. The case is based on the experiences of many developing countries where the overvaluation of the exchange rate is seen as pro-imports and anti-exports. This is because overvalued exchange rates subsidise imports and importers pay less per unit of foreign currency. The anti-export bias arises when an implicit tax is imposed on exporters who receive less when they convert their foreign exchange earnings into local currency at a rate, which is administratively set and overvalued. Exporters will have no incentive to engage in cost-reducing technologies to compete in the international market. Hence, the demand for cheap imports and the fall in official exports leads to a widening gap in the trade balance, which can only be financed by running down reserves or donor import-support (IMF, 1987). Low level of reserves means a poor balance of payments position. The fall in official exports also means reductions in trade related tax revenue. Public revenue is also affected by selling foreign exchange cheaply to importers. The local currency equivalent of foreign savings could have been higher if the exchange rate was determined by the market or is devalued. In the face of falling revenue governments resort to deficit financing which leads to inflation. The fall in the implicit government revenue, which is financed by purchasing foreign exchange cheaply from exporters, is compensated by selling foreign exchange obtained from donor import-support at a devalued rate (Jamal, 1991).

Another argument for devaluation is related to rent-seeking and wasteful administration activities typically encouraged by overvalued exchange rates and the associated import licenses and exchange controls. Devaluation reduces benefits to

favoured groups that have access to rationed foreign exchange and import licenses and eliminates inefficient rents that accrue to middle- and upper-income urban groups (Krueger, 1974). The general argument in favour of exchange rate policy is that the alternatives focuses on frustrating imports, while devaluation is designed to encourage exports. The alternatives to explicit devaluation are selective taxes and subsidies, multiple exchange rates, capital control and exchange controls. These are criticised for being inferior to exchange rate depreciation for a number of reasons. First, identification of the areas, which need fiscal stimulus, involves various information costs as well as the cost of implementing and monitoring taxes and subsidies. Devaluation is preferred for its uniformity in impact (Laker, 1981). Policies, which can be manipulated within central banks or the ministries of finance and with less need for legislative sanction or complex institutional planning, and to which political barriers are smallest, are preferred (Mosley, 1991a).

Second, the use of multiple exchange rates, for instance, a high exchange rate for key export commodities and essential imports and low exchange rate for infant-industry exports and luxury imports, proves to be administratively difficult due to linkages among these sectors (Streeten, 1976b). Third, exchange controls, have direct impact on imports through encouraging necessary items and discouraging unnecessary ones. By discriminate among imports, controls cannot possibly differentiate between essential and no-essential imports and the administrative costs in any case are high. Controls lead to corruption and rent appropriation by government officials as well as illegal trade such as smuggling (Killick, 1978 and Killick, 1980). It has also been found that domestic firms will not have the incentive to expand their scale of production and attract extra foreign exchange (Stern and Falcon, 1970). Exchange controls also constrain the expansion in exports, as imported inputs for export production are limited. Exchange controls, by discouraging imports of non-essential goods in fact encourage domestic production of such substitutes as well as encouraging capital-intensive production in labour-surplus economies (Krueger, 1978 and Bhagwati, 1978).

Fourth, overvalued exchange rates discriminate against exports and shields domestic producers from international competitions. Overvaluation induces capital flight among domestic citizen anticipating further devaluation. As a result, less foreign exchange is available for imports. Foreign exchange may be rationed and allocated inefficiently and efforts to defend an overvalued exchange rate through tight monetary and wage policy may cause recession as prices and wages are inflexible (Sachs and Larrain, 1999 and Shatz and Tarr, 2002). However, consistent efforts to defend the exchange rate through trade protection are futile, as ultimately falling reserves will force devaluation (Shatz and Tarr, 2002).

Fifth, due to exchange rate misalignment productivity gains and hence growth will be curtailed in export and import-substituting sectors. Exchange controls and trade restrictions exacerbate the situation (Edwards, 1989 and Cottani, *et al.*, 1990). These findings have also been attributed to low growth, low investment, low level of savings, and low-level of trade in SSA (see Ghura and Grennes, 1993). Particularly the fixing of the CFA franc to the French franc up to 1994 in francophone West Africa, which experienced higher growth, is said to have led to slow growth (Elbadawi and Majd, 1996). The CFA zone was growing favourably until 1986, but saw a declining growth as the French franc appreciated and the terms of trade deteriorated (Clément, 1994). Those severely affected by the overvaluation, Cameroon and Cote d'Ivoire, saw an improved growth after the devaluation of the CFA franc in 1994 (Azam and Devarajan, 1997).

### 3.5.1 Expenditure-Switching Contested

The IMF's approach is based on the standard theory of the exchange rate – the price of the currency – and its adjustment in order to correct a balance of payments surplus or deficit. The focus is on the relationship between the exchange rate and the country's trade flows, or its imports and exports – similar to the traditional elasticities approach discussed above. The basic idea is that the equilibrium exchange rate balances the country's foreign trade. If there is a trade deficit, and import expenditure exceeds

export earnings, then the price of the currency needs to decline. This would make exports cheaper, and foreign demand for them will increase; at the same time, imports become more expensive, and domestic demand for them declines. This process should continue until the trade balance is established. This approach assumes that international capital flows are not autonomous and, therefore, only arise to meet imbalances in trade flows. The assumption behind IMF policies is that exports and imports are responsive to prices so that capital and intermediate goods could be substituted without causing disruptions in investment and output. This is based on extremely restrictive assumptions. In the mainstream analysis, to increase the production of one commodity, say, coffee, one other commodity must be sacrificed. However, unless other unrealistic assumptions of perfect mobility of factors of production and free trade are introduced, there is no guarantee there will be smooth expenditure-switching (Weeks, 1995 and 1999).

Exchange rate liberalisation – based on the assumptions of flexible economies and instantaneously clearing markets – has serious limitations. Too much emphasis on the mainstream neoclassical aggregate supply functions fails to take account of peculiarities of developing economies. The structural rigidity or flexibility of developing economies is not taken into consideration (Taylor, 1993b). The models do not also take changes in relative prices and the terms of trade (Katseli, 1983). First, inflation-cum-balance of payments problems are inherently related to the structure of production and distribution; and second, the response of primary exports need more than just relative price changes. Policies such as investment programmes and targeted subsidies must be considered. Policy prescriptions should fully capture bottlenecks and rigidities in the process of production and consumption (Taylor, 1988).

Devaluation sidesteps the production side of the economy disproportionately focusing on the exchange side. The Washington consensus associates correcting market failures in exchange with correcting market failures in production. Successful East Asian economies adopted a strategy for building a modern and competitive production base through “getting prices wrong” and purposeful formation of “distortions” to expand investment in productive capacity in the realm of firm-specific knowledge, differentiated

products, patents, scale economies, externalities, research and development (Amsden, 1989 and 1997). Similarly, for the least developed countries of SSA, new agricultural technology spurred by research and development is found to be one of the significant inputs necessary for successful export-led growth (Sanders *et al.*, 1990). Agricultural policy can induce rural household demands and facilitates backward linkages through agricultural development (Vogel, 1991). Increased agricultural productivity via technological diffusion and higher rural income produces additional rural household consumer demand and increased food supply for nurturing industrialisation (Adelman, 1984). If export promotion is the strategy, structural problems must be improved through export subsidies and public investment (Stewart, 1994).

Constraints to export expansion in developing countries are not only prices but also income related. External demand determines exports more than relative prices do. With the adoption of common stabilisation programmes—hence more devaluation by a majority of identical commodity producer countries—there is danger of a fallacy of composition effect. This is related to the demand for developing countries' exports in developed countries and the latter's absorptive capacity. In discussing whether the East Asian model of development can be generalised, Cline (1982), found that if all developing countries increase their manufactured exports, consumption capacity in the G7 countries being limited, provokes retaliation thorough protective measures. Cline notes that since South-South trade is weak, their bargaining position is also weak. Even diversification of developing country exports as well as growth in developed countries would not be adequate as high penetration ratio (15 per cent at the time) was reached. Cline (1982, p. 88-89), notes:

“the market in industrial countries would grow along with income but would not reduce the estimated import penetration ratios even with a time dimension in the analysis, because GDP levels in developing countries (and therefore the base for their manufactured exports) would also be growing overtime, probably more rapidly than income and markets in industrial countries...Other developing countries would be well-advised to adopt similar policies but ill-advised to expect free market policies to yield the same results that were achieved by the East Asian economies, which took advantage of the open-economy strategy before the export field became crowded by competition from other developing countries, and did so when the world economy was in a phase of buoyancy.”

The constraints imposed upon developing countries' export growth by international demand are real as confirmed by a recent report from United Nations Conference on Trade and Development (UNCTAD, 2000). A study of manufacturing export demand functions from a partial equilibrium point of view finds that the elasticity of export demand is small. For 23 developing countries another study finds that international demand impacts upon export growth for small countries (Faini *et al.*, 1992). Less technologically advanced and labour-intensive exports are vulnerable (Martin, 1993 and UNCTAD, 2000).<sup>11</sup> Almost 80 percent of the benefits of exchange rate depreciation disappear when other developing countries' competitors pursue similar policies. China's membership of the WTO and entry of other South Asian economies into the export market also created extra supply in labour-intensive manufacturing. The terms of trade for labour-intensive manufacturing has been worsening especially for those low-skill and low technology manufactures. Fallacy of composition has also been found to be dynamic, related to the structural change and aggregate demand conditions in both the exporting and importing countries. China, for instance, is currently occupying the market vacated by the East Asian economies. As the latter moved to high-skill and high technology intensive exports, following the move by the developed G7 countries into information and communication industries, China moved into less skill and technology intensive export market (Mayor, 2002).

Identical commodity export expansion, particularly coffee, cotton, cocoa, banana, tea, tobacco, copper and petroleum; by, for instance, SSA countries leads to the fallacy of composition problem and reduced prices turning the terms of trade against exporters (Bleaney, 1993; Akiyana and Larson, 1994 and Schiff, 1995). The advice of IFI's to a number of SSA countries to liberalise and increase exports of traditional commodities has been unfavourable (Weeks, 1995). Little evidence was found to substantiate the claim that exchange rate liberalisation has removed the bias against exports, thus encouraging export expansion to fuel economic growth in SSA economies. Because of dependence on primary commodity exports trade liberalisation alone could not be an incentives to agricultural producers. Complementary agricultural sector reforms are necessary to



ensure that world prices are transmitted to producers and that producers' ability to respond is facilitated (McKay *et al.*, 1997). The same point is made by (Singer, 1995, p. 17), who stated:

"The slippage of global management out of the multilateral system has also affected the impact of stabilisation/structural adjustment programme. IMF and World Bank missions proceed on a country-by-country basis, without much of a general overview. A mission in Ghana may recommend increased "outward orientation" involving more cocoa exports, at the same time that missions in Ivory Coast, Ecuador, Brazil or Indonesia make similar recommendations. This amounts to a "fallacy of composition": Ghana might benefit if it alone increased cocoa exports, but if all the countries do the same, the predictable result will be over-supply and a collapse of cocoa prices, with general immiseration"

The timing of devaluation is also critical since tree-crops and minerals depend on harvest and gestation periods. Moreover supply response to devaluation depends on the characteristics of commodities (crops or minerals). The implication is that structural characteristics determine adjustment outcomes (Loxley, 1990). The idea that devaluation releases exportable goods from local consumption and prevents imports from competing with locally produced goods is questionable. Lack of vital inputs such as fertilisers and transport infrastructure constrain export diversification. In this case the trade balance denominated in domestic currency widens, resulting in an increase in the proportion of imports in gross national income (Cline, 1983). Empirical work is yet to determine the degree of substitution between tradable and non-tradable goods. As noted by Katseli (1983), initial increases in production costs in non-tradable sectors might reverse desired outcomes against the desire to increase prices of tradable goods relative to non-tradable goods. Alternatively, prices of non-tradable goods might also increase by the same proportion as devaluation, if wages are fixed or indexed to consumer prices.

As far as long-term growth is concerned primary commodity production on the one hand and long-term growth objectives such as technological learning, human capital development, industrial development and regional trade (which require increased public expenditure and co-ordination) are incompatible, as pointed out by the *export pessimism* literature (Stewart, 1992).<sup>12</sup> Competitive advantage must go beyond the concept of market share. Successful trade depends on the productivity labour and capital, which

includes the four “diamonds” that increase productivity and improve competitiveness: factor conditions, demand conditions, related and supporting industries and firm strategies, structures as well as rivalries. The relationship within the “diamond”, mainly vertical (buyers and suppliers) and/or horizontal linkages (common customers, technology and channels), information flows, innovation, and new entries from spin-offs from related industries; determine competitiveness (Porter, 1998).

Long-term diversification objectives can only be achieved by designing technology policy, improving organisational, marketing skills and human development, which the market cannot guarantee, and only an orchestrated public expenditure programme, unfettered by IMF stabilisation and adjustment programmes, can achieve these objectives (Wangwe, 1994). For instance, Cheru (1992) points out where state support to farmers is reduced, it has led to destruction of the environment due to shortages of arable and cultivable land.

Unless tight monetary and fiscal policies are introduced, the short-term impact of devaluation may be its deflationary impact (Bird, 1983). Whether the inflationary pressure continues and builds up as a permanent cost-push inflationary pressure depends on the extent of import intensity of domestic production, the ability of domestic firms to pass on the price increases to domestic consumers, how strong money-illusion persists as well as bargaining power of wage earners, and how the government responds to restore wages through credit creation. In many cases it has been found that prices continued to rise as domestic credit expansion continued after devaluation, rendering the effort to change relative prices futile (Taylor, 1988).

### **3.6 Privatisation**

This section is intended to cover the important issues in privatisation, which the IMF is increasingly pushing forward as part of its adjustment programmes. The discussion below assesses the theoretical and empirical foundations of privatisation

policies and evaluates its compatibility with the broader objective of stabilisation and adjustment. The aim is to show the IMF's broadening of objectives through adoption of neo-liberal thinking without having developed a framework to incorporate adjustment policies formally. The IMF argues that investment programmes should flow to "directly productive sectors", with emphasis on businesses financed mainly by domestic private investment and foreign capital. The objectives, among others, are to reduce state interference; foster private sector participation; broaden ownership of assets; improve the efficiency of enterprises, cultivate a culture of competition; and improve the government's fiscal position (IMF, 1987 and World Bank, 1995a).

Broadly, privatisation is defined as the transfer of productive assets as well as provision of property rights to the private sector with full control over production, pricing as well as profits in previously state dominated domains. The forms of privatisation include out-right sale of public enterprises, divestiture, leases, management buy-outs, and sub-contracting. State assets can also be sold at zero prices through voucher schemes or services can be contracted out to the private sector such as park cleaning. The method of privatisation depends who buys the enterprises, which includes foreign investors, domestic individuals, shareholders, managers, employees, banks, mutual funds and corporations. The sale decision also depends of how to transfer assets or entitlements, which include tenders, auctions, private negotiations, and stock market floatation. Governments also enter into joint ventures, majority or minority stakes (Vickers and Yarrow, 1991).

As the "market failure" argument gave rise to public ownership of certain enterprises, the "government failure" logic also led to privatisation. The latter was supported by developments in mainstream economics under the New Institutional Economics, New Political Economy and the Austrian School, which emphasised public choice, property rights and principal-agent theories as justification for private ownership (Vickers and Yarrow, 1995). The theoretical framework underlining privatisation is based on welfare economics and is described as the New Synthesis (Fine, 1997). These theories together provide the intellectual justification to pursue the transfer of public assets to the

private sector. The central conclusion of the synthesis is that privatisation improves the efficiency of enterprises, increases competition, improves the government's fiscal position, develops the private sector, reduces political interference and reverses the ideology of state-ownership. For the IMF, privatisation is attractive as it relieves the short-term fiscal imbalance. In the long run the economy will move towards a competitive environment by dismantling distortions associated with government intervention.

As far as the efficiency enhancing aspect of privatisation is concerned, proponents argue that it enhances productive as well as dynamic efficiency. The former refers to the opportunity created to engage in low cost current production techniques, and the latter refers to improving overall performance through new techniques and novel production processes. These static and dynamic efficiency types bring about internal efficiency at a firm level and allocative efficiency at economy wide level, where production meets social need signalled by the equating of prices with marginal costs. At the same time the government's fiscal position improves through gains from sale of enterprises, savings made from subsidising unprofitable enterprises, and new tax revenues from the privatised businesses (Cambell-White and Bhatia, 1998).

With the neo-liberal ascendancy state-owned enterprises have been singled out for price distortions and the fiscal crisis, despite consistent reforms introduced to improve the sector. Among the causes for poor performance of enterprises, political interference in management decisions as well as shielding enterprises from competition have been mentioned as the two most important (Tangri, 1995). Among the privatisation methods used in SSA, sales of shares through competitive tender as well as formal liquidations and asset sales were the most pervasive. There is evidence that public assets were sold by undervalued price for the purpose of widening share ownership. In some cases the voucher scheme also transferred public enterprises free of charge to employees. These reflect the fragile state most enterprises were in terms of profitability and efficiency (Cambell-White and Bhatia, 1998).

Theories of privatisation are unduly pessimistic about the motivation of state-run enterprises, by assuming that governments are individual utility concerned. Social welfare goals such as access to basic services by low-income groups can successfully be organised by state-owned enterprises (Singer, 2001). As Vickers and Yarrow (1991) note: “public ownership may have the advantage if externalities are larger and the pursuit of personal agendas is more constrained, for example by a well-functioning political system” (p. 113-114). The impact of privatisation and the transformation of enterprises into a full-fledged efficiency driven capitalist firms is not explicitly addressed. For instance, private ownership is not superior and large private enterprise can equally be bureaucratic and highly inefficient (Chang and Singh 1993 and 1997). Privatisation may actually lead to concentration of the market structure, as there is scarcity of capital particularly in less-developed countries. This is also confirmed as the private sector often shows interest in sectors with less competition (Commander and Killick, 1988 and Kikeri *et al.*, 1992). Privatisation may lead to competition at firm level but it is not clear how that can be aggregated at the national level. Privatised firms can also be inefficient and bureaucratic due to the “free-rider” problem in shareholder monitoring. Various interests and particular institutional cultures determine shareholder’s decisions and widespread ownership make monitoring firm operations complex (Fine, 1997).

The theory and practice of privatisation suffers from neglect of sectoral and national allocative efficiency as well as ill-defined demarcation between state and private ownership. The experience of privatisation suggests that there is no evidence that ownership by the private sector is superior over ownership by the public sector as far as efficiency of enterprises is concerned. Privatised firms showed no significant difference in performance compared to state-owned enterprises (Berg and Shirley, 1987). Studies in Latin America show that state-owned enterprises actually outperformed the private sector (Saulniers, 1984 and 1985). Large state-owned enterprises are linked with low economic growth, rendering the hypothesis of downsizing the state sector irrelevant from growth perspective (Jalilian and Weiss, 1997). In practice privatisation does not also mean government intervention is completely terminated. There are cases where strict regulation

as well as subsidies continued even after privatisation as was the case with Chrysler in the US and Leyland in the UK (Vickers and Yarrow, 1991).

The privatisation process in SSA Africa is not uniform; some have adopted quick and large privatisations such as Mozambique, while others such as Ethiopia opted for slower and privatisation of small to medium enterprises.<sup>13</sup> In some cases where large privatisations took place the state also maintained a majority ownership. The overall evidence on privatisation in developing countries shows that not enough privatisations were actually carried out in the 1980s contrary to the IFI's rhetoric (Gelb and Gray, 1991). The same is true for the 1990s, although the privatisation process was speeded up; only small enterprises have been privatised (Amsden *et al.*, 1994). Particularly, privatisation in SSA has been slower than other regions (Bennell 1996 and 1997 and Ramamurti, 1999).<sup>14</sup> A survey of a number of SSA countries also shows that the post-privatisation period, in terms of profitability and efficiency, was not markedly different compared to the pre-privatisation period. The only effect has been an increase in capital expenditures (Boubakri *et al.*, 2002). Nellis (1999) notes;

“the association between private ownership and restructuring (changes positioning the firm to survive and thrive in competitive markets) is weak or non-existent; firms that are partially owned by the state perform better than privatised companies; few differences are discernible between the performance of state-owned and private firms; clear performance improvements are evident only in the few firms that have been sold” (quoted in Carlos, Cramer and Hailu, 2003).

The success of privatisation is limited where institutions are weak. In four case studies of telecommunications and water sectors in Africa it was found that the performance of privatised industries is determined by how much other institutions are developed such as contract enforcement, competition and regulation policy (Shirley and Adam, 2002). The experience of SSA is consistent with findings in the former Soviet Union and Eastern Europe, which shows that fast privatisation was found to be not effective (see Stiglitz, 1998a, 1999a, 2002, Solnick, 1998 and Nellis, 1999). Privatisation has been less successful in Central and Eastern Europe because of legal and institutional weaknesses and because mass privatisation techniques, though widely employed, were

poorly conceived for delivering performance improvement in such an environment (Estrin and Goldstein, 2002). Weak post-privatisation regulatory frameworks, under concentrated market structure, undermined the success of privatisation (Ramamurti, 1997).

There are plenty of cases where transactions have been concluded through uncompetitive methods. The privatisation process more often than not suffers from lack of accountability and transparency (Adam *et al.*, 1992 and Cambell-White and Bhatia, 1998). Various country experiences reveal that the award of concessions and contracts – and hence the process of privatisation – is a major source of corruption (Hall, 1999). Although the public sector is vilified for corrupt practices, the private sector can be equally corrupt (Haque, 1996). Privatisation must be seen as a political process where rewards are made and major distribution of wealth from public ownership to private capital takes place (AppiahKubi, 2001). The relationship between the level of privatisation and the level of corruption exhibits an inverted U-shape (Laffont and Meleu, 1999). This is due to the interest shown by government officials to be compensated by the newly created firms, for the loss of revenue due to privatisations.

For instance, Mozambique's privatisation has been one of the largest, by number of transactions, in sub-Saharan Africa and this is the main basis for claims that the programme has been one of the most successful. However, privatisation has been hasty and careless. Contrary to the public finance objectives of privatisation, there has also been a form of subsidy to the private sector, through payment deferral and default. This subsidy is indiscriminate, unplanned and highly inefficient (Cramer, 2001 and Castel-Branco, Cramer and Hailu, 2003). Zambia's privatisation was also held as a showcase (Cambell-White and Bhatia, 1998). But it is a deeply flawed experience, which allowed for corrupt acquisition of assets by those linked to the ruling elite, reflecting the political and economic environment. This required the Zambian government to balance, on the one hand, the demands of the IFIs that international capital should be provided with an attractive and secure environment for investment and, on the other hand, those in the ruling party and urban capitalists who regarded privatisation as an opportunity for

personal accumulation (Craig, 2000). The incidence of corruption is closely connected with contracting-out and concessions, where multinationals stand to gain from profitable businesses. The encouragement of privatisation and the involvement of multinationals require greater political transparency to remove the secrecy under which corruption flourishes, and resistance to the uncritical extension of privatisation (Hall, 1999).

The losers from the privatisation process often are workers (Galal *et al.*, 1994). The post-privatisation period has a negative effect on morale, as workers felt less secure of their jobs (Haque, 1996). The privatisation process also creates new alliances and new conflicts among various social classes. For instance, public sector trade unions have been in conflict with governments in defence of cuts in the labour force. In many countries trade unions have developed their own models and proposals for modernisation of public services, but these often fell on deaf ears (Waghorne, 1999). The effects of privatisation and deregulation of the Dar es Salaam transport system on transport supply was non-compliance with safety rules, inefficiencies in the fare structures and exploitative conditions of employment (Rizzo, 2002). Although governments gained large sums of money from privatisation, high outstanding credit sales, high costs of divestiture and high outstanding liabilities of privatised firms eroded much of the gain, particularly in Latin America (Ramamurti, 1992 and 1996a). Privatisation simply reduces the role of state to regulatory functions and neglects the role governments need to play in providing vital services such as sanitation, electricity, water, light, health, education as well as formulating industrial policy and foster capital accumulation through intervention (Adam *et al.*, 1992). One example is the stance on privatisation whereby state intervention is required to prevent monopoly profits. As Stiglitz (1999a, p. 3) notes the Washington consensus relied too much on textbook economics;

“Textbook economics may be fine for teaching students, but not for advising governments trying to establish a new market economy—especially since the typical American style textbook relies so heavily on a particular intellectual tradition, the neoclassical model, leaving out other traditions (such as those put forward by Schumpeter and Hayek) which might have provided more insights in to the situations facing the economies in transition.”



### 3.7 Concluding Remarks

As shown above, IMF programmes, since the mid-1980s, began to address structural issues under adjustment policies, which fall outside of its original mandate. Such broadening of objectives would logically lead to extension of the formal models. However, there is no evidence that this is taking place. The IMF still displays the basic financial programming model as its key conceptual tool while the other policies are added on *ad hoc* basis. The economic models attached to the adjustment package are based on mainstream exchange rate, trade and financial liberalisation, privatisation. What is clear from the analysis is that the supply-side contents of IMF policies, which have been prescribed with the FP framework, are not coherent models and rely on developments in macroeconomic theory. This development has been heavily influenced by neo-liberal considerations, which it self is subject to many flaws as is evident from the critique.

Conceptually, the inclusion of supply-side adjustment policies has also involved the attempt to integrate the FP framework with the World Bank's RMSM. This attempt, in contrast to borrowing *ad hoc* from mainstream economics, is an attempt to close the FP model so that long-term growth determinants are included. However, the merging of the two models remains an esoteric theoretical adventure, rather than a comprehensive stabilisation and adjustment model. This is manifested by: 1) the lack of interest in merging the models by other concerned researchers, aside from staff of the Fund's and the Bank's Research Departments; and 2) its theoretical inadequacy to formulate balance of payments and growth framework.

The Theory of the Second Best pioneered by Lipsey and Lancaster (1956) seems to have not been taken up by the advocates of adjustment programmes. The Theory implied that in the presence of many market imperfections or distortions the removal of any one of these would not make the economy work better. The mainstream assumption

and the empirical wizardry seems to suggest that few distortions are better than many (Chang, 1999). As Mosley (1991a, p. 227) notes:

“but there is nothing in economic theory to tell us which distortions should be removed in which order, or even that it will necessarily help if any one distortion is removed...whereas it is common ground between all parties that aggregate demand needs to be reduced (whether through cutting expenditure or raising taxes) if an economy's balance of payments or inflation problem is to be stabilised, there is no common ground concerning the right way to increase aggregate supply for those wishing to embark on a structural adjustment programme; there is no analogue on the supply side, wither in the World Bank or any where else, to the IMF's “Polak Model”, which prescribes the amount by which domestic absorption must be reduced if the balance of payments is to be improved by  $\$X$ .”

Improving the overall process of financial intermediation by deregulating markets and raising real interest rates through financial liberalisation is a slow-acting remedy. Investment depends on expectations of future demand and prices do not clear instantaneously as predicted by the model. Country experiences show that financial resources mobilization requires intervention to influence interest rates and manage credit allocations. Special attention need also be given to the peculiarities of community based local networks and traditional familial relationships in financial transactions. Although trade liberalisation is beneficial and can be an “engine of growth”, reduction of QRs and other barrier do not necessarily improve trade balances. The market need to be augmented by sector-specific policies such as research and development expenditure, technological advances, and improving quality of products. Depreciation of the exchange rates also fails to switch expenditure if both exports and imports are not responsive to price changes. Removing key structural rigidities, targeted investment programmes and subsidies need to be constituted. Private sector participation is productive only if the state has adequate regulatory capacity, if the privatisation process is not marred by corrupt practices, and if a truly competitive environment is installed. However, the experience shows these not to be the case.

It is, therefore, neither justifiable nor effective to continue prescription of orthodox macroeconomic policies. The question is whether a need for appropriateness,

relevance and efficacy of IMF programmes amount to alternative policy packages. This is a big question that can only be answered in one way: before the alternative is embraced, there should be strong empirical evidence that shows whether IMF stabilisation and adjustment programmes work or not in practice. The concern of the next chapter is exactly that: to review the empirical literature and examine the evidence on the impact of IMF-supported programmes.

## Notes

<sup>1</sup> Recently Khan and Sharma (2001, p. 20) argued for more extensive intervention in stabilisation policy because of lags in responses and underlying distortions in economies precluding adjustment. Earlier Schadler *et al.* (1995, p. 50) noted that conditionality has been extended beyond demand restraint to include supply-side measures, which focus on "saving, investment, and output during the adjustment phase" As far as development is concerned, however, the division between demand side stabilisation and supply side adjustment is an artificial one. As Bird (1995, p.70) asks "[W]here does one end and the other begin?"

<sup>2</sup> The Berg Report is the same as World Bank (1981).

<sup>3</sup> Note:  $dK = (Y_t - T - C_p) + (T - C_g) + (Z - X)$  and substituting for  $C_p$  and  $Z$  [ $dK = s(Y_t - T) + (T - C_g) + (\mu Y_t - X)$ ] yields equation 3.64.

<sup>4</sup> Note:  $Y_t = Y_{t-1} + dY$  and all borrowings ( $dB_{pg} + dB_{fg} + B_{pg} + dB_{fp}$ ) between sectors are omitted for simplicity.

<sup>5</sup> Agénor and Montiel (1996) state;

"We do not believe that economic agents in developing countries behave differently from those in industrial economies in ways that are inconsistent with the rational optimising principle of neoclassical microeconomics; rather, we believe that they behave similarly to their industrial counterparts, but operate in a different environment. Our perspective is that the standard analytical tools of modern macroeconomics are indeed of as much relevance to developing countries as they are to industrial countries, but that different models are needed to analyse familiar issues" (p. 11-12, quoted in Fine and Hailu (2001).

<sup>6</sup> Khan *et al.* ignore the emphasis of the merged model on the short run and focus on other limitations, for instance, the exclusion of an analysis of the interest rate and wages. However, the authors also claim an inclusion of such variables complicates the model, to which simplicity is said to have been its important attribute. Mikkelsen (1998) also notes that the FP framework could be modified and "an external debt bloc would be useful in order to give a more complete description of the debt dynamics" (p. 16).

<sup>7</sup> The relationship between financial development and economic growth has been further strengthened through endogenous growth models (Hermes and Lensink, 1996 and Levine, 1997).

<sup>8</sup> As the neo-structuralist critique also points out prices are determined by mark-up decisions, wages are determined by conflict between labour and capital, and the informal financial sector is significant in developing countries. Unlike the Post-Keynesian model, neo-structuralist explicitly takes the credit market into consideration. The former school assumes the demand for money is endogenous, which excludes explicit analysis of the demand for credit.

<sup>9</sup> This effect is known as the Factor Price Equalisation theorem or the Stolper-Samuelson theorem.

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<sup>10</sup> The reverse argument is also that the environment can be protected by creating incentives and disincentives in the production and export of a particular commodity through trade liberalisation.

<sup>11</sup> The fallacy of composition effect is also similar to Bhagwati's (1958 and 1968) "immeseizing growth" that demonstrated economic growth, which increases a country's exports, can lower its welfare (see also Bhagwati and Onitsuka, 1974). The welfare loss could be offset if a country sets the optimal trade tax to neutralise the terms of trade effect. Expanding the analysis to multi-country exports Bandyopadhyay (1996) finds that exporters must achieve tacit collusion to set the optimal trade tax to offset the welfare loss. From general equilibrium perspective fallacy of composition argument have been challenged. Increases in exports by developing countries raises their income as well as their demand for imports from the developed economies. Thus, if technological advances and investment back export growth, the fallacy of composition may not hold (Havrylyshyn, 1990).

<sup>12</sup> See Sarkar (1992) and Deaton (1999) for an account of the relationship between commodity prices and growth in developing countries, particularly SSA.

<sup>13</sup> See Jones and Kumssa (1999) on the merits and de-merits of a shock therapy model for liberalisation of markets including privatisation.

<sup>14</sup> Latin American economies gained a large sum of revenue from privatisation. However, in terms of numbers Europe and Central Asia comes first (Ozkaya and Askari, 1999).

# Chapter 4

## The Impact of IMF Programmes: The Empirical Evidence

### 4.1 Introduction

Despite the proliferation of IMF programmes, the economic ills in the least developing countries continue to baffle all interested parties. The recovery question and particularly the popular “remedies”, stabilisation and structural adjustment programmes, have attracted academic as well as professional attention. One of the most researched areas is the impact of these programmes on various economic and social variables. An examination of the various statistical studies of the last three decades on the impact of IMF programmes shows that the results to be hopelessly inconclusive and beset with serious methodological problems.

As we have seen from the previous chapters the analytical framework for formulating IMF programmes focus mainly on short-term macroeconomic stabilisation, while long-term structural adjustment and other broader objective are constantly incorporated. An influential recent report pointed out that despite many attempts it has not been possible to link IMF programmes with increased growth performance (Meltzer, 2000). Yet Khan and Sharma (2001, p. 12) argue, “on average, IMF-supported programmes and the conditionality they incorporate, have been reasonably effective in achieving their main macroeconomic objectives”. The claims and counter claims around the efficacy of stabilisation and adjustment programmes have produced a rich empirical literature. Earleir survey of the literature on determinants of *ex ante* IMF lending, design and implementation and *ex post* impact is found in Khan and Ul Haque (1998) and IMF (2001a) and Joyce (2002). Through a fresh survey of the available impact literature, this thesis finds that none of the studies come to definitive conclusion, not to mention the methodological pitfalls.

The major issues in assessing the effectiveness of stabilisation and adjustment programmes are set out in Guitian (1981) and Williamson (1983c). The problem of measuring the counterfactual (i.e., what would have happened in the absence of IMF programmes) is one of the most important aspects addressed in the literature. Since the counterfactual is unobservable and impossible to measure directly, the consensus is to identify a methodology that allows approximation. But the problem remains unresolved, as one cannot compare the approximation with the counterfactual, which is not known in the first place.

The studies employed various methodologies to assess the effect of IMF programmes, which included the before-after, the with-without (also referred as the Control-Group), the modified with-without (Generalised Evaluation Estimator, GEE) the multiple regression/structural model, the actual vs. target approaches, as well as studies to determine programme continuity, compliance and sustainability. The before-after approach compares the change in target variables between pre-programme and programme periods usually for one year. The counterfactual is assumed to be the pre-programme period. The major shortcoming of this approach is that it ignores exogenous factors such as changes in the terms of trade and international interest rates that affect macroeconomic performance. If, for instance, the terms of trade were deteriorating in the pre-programme and improves in the programme period, it is likely that studies which compare the before and after changes in target variables will overstate the true effect of the programme and vice versa.

Another methodology is the with-without approach, which compares changes in target variables for programme countries to a group of non-programme countries. Here, the counterfactual is represented by outcomes in countries without IMF programmes. Nonetheless, since countries implement IMF programmes because they experience macroeconomic problems, those countries that are not implementing such programmes can hardly be a good measure of the counterfactual (Krueger, 1998b). This is one of the problems of the with-without approach, which does not take account of systematic differences between programme and non-programme countries. In other words the technique suffers from selectivity-bias. Selectivity-bias means that the failure to control for systematic differences between programme and non-programme

countries. Since programme countries are likely to have identical macroeconomic difficulties, for instance, suffer from an unsustainable current account deficit, the selection represents a non-random sample. A technique acquired from the literature on labour training evaluation, the Generalised Evaluation Estimator (GEE), attempted to incorporate numerous factors to accurately capture the counterfactual (Goldstein and Montiel, 1986). Although the GEE technique controls for *observable* differences between programme and non-programme countries, sample-selectivity bias would remain because unobservable differences between programme and non-programme countries remain.<sup>1</sup>

Other researchers use the multiple regression approach, which uses a single or simultaneous regression equation to determine each target variable. The method uses a standard dependent-independent variable regression model and the choice of independent policy variables and expectations of the signs on the coefficients are determined by the theoretical framework in which the model is tested. This approach has some limitations. Firstly, it does not explicitly weigh up the impact of IMF programmes nor does it measure the counterfactual. It merely demonstrates statistical relationships between target and policy variables. This approach does not make clear whether the test is on statistical dependence, or on the goodness of the macroeconomic model or the hypothesis concerning the country. Secondly, the Lucas critique applies to it, that the coefficients econometricians estimated may not be constant if policy makers change their policy: the models up to that point were wrong. This is because coefficients incorporate agents' knowledge about the way that policy reactions occur. Therefore, it is possible that the coefficients will also vary with changes in policy. The exercise becomes pointless, as no parameter remains fixed. This critique is damaging especially to forecasting, because parameter constancy is imposed on macroeconomic models when deriving predictions (Lucas, 1976). In addition, the possibility of capturing individual country differences by aggregated cross-section analysis is problematic. Each country has a distinctive political characteristic, a distinct institutional makeup, and a particular combination of policies. A principal question for the impact studies is whether aggregating individual country performance in a single standardised model gives accurate results; the answer is to the negative (Dicks-Mireaux *et al.*, 2000).



Another, and less popular, technique of impact analysis is the actual vs. target approach, which compares *ex post* actual outcomes in target variables with targets set *ex ante*. This technique avoids the issue of the counterfactual and concentrates on whether the IMF's and the authorities have met what they have set out or not. But, the adequacy of the actual vs. target method is also doubtful, as targets may be set at unrealistic level or their attainment is hindered by exogenous factors. The IMF's broadening of objectives in adjustment as well as its increasing interest in poverty may also mean proliferation of targets and instruments that encourages partial achievement. For instance, setting targets for reduction in the level of domestic credit and devaluation of the local currency by a certain percentage may fail to achieve an improvement in the balance of payments due to unfavourable terms of trade effect. However, if, at the same time, targets were set to the interest rate, privatisation, domestic price liberalisation etc., some of the objectives may be achieved justifying claim for success or damning criticisms.

A survey of the empirical evidence in this thesis comes up with three broad conclusions (see Table 5.1 below). First, out of the 26 studies surveyed only 9 found a positive impact of IMF programmes on growth. Out of the 9 positive results 2 were found to be statistically insignificant, while 9 studies found negative impacts and 8 found no effect at all. Second, out of the 23 studies 11 found a positive impact on the current account, while 7 studies found negative impacts and 5 studies found no effect. Third, out of the 22 studies that examined the impact of IMF programmes on inflation, 9 found positive effects. Out of the 9 positive results 1 is found to be statistically insignificant, while 6 studies found negative effects and 7 found no effect. Fourth, an interesting finding of the impact literature is that absence of private capital flows following IMF programmes. Empirical studies have also shown that there is no evidence to verify the catalytic effects of IMF programmes, particularly private capital inflows (Rodrik, 1996b; Edwards, 2000; and Bird and Rowlands, 2001). The finding in this thesis compares and contrasts with an earlier survey of the empirical evidence, which suggests that the impact of IMF programmes on the current account is positive. The impact on inflation is not yet conclusive and as far as economic growth is concerned the studies find a decline in the short run and an increase in long run (Khan

and Ul Haque, 1998). The survey in this thesis agrees with the comment on inflation and not with the current account and growth.

The diversity of the results obtained by the published studies is surprising since most of the researchers seem to have based their estimates on similar economic theories, seem to have used approximately the same data series, and applied similar methodologies. The questions, therefore, are why their results produce quite dissimilar results and how successes or failures are explained. The answer for the first question will become apparent from methodological weaknesses as well as the inadequacy of the programmes themselves. The latter issue is discussed in the previous chapter as part of the critique of IMF programmes. The answer to the second question is the (mis)use of state-society relations to explain success or failure, that interest groups and rent-seeking impede successful implementation of IMF programmes (this issue will be taken up in Chapter 7). The main concern of this chapter will be on the methodological weaknesses.

A methodological problem affecting all statistical studies in this survey is related to the problem of using annual data while IMF programme may start at any time of the year. All of the studies reviewed include data on annual basis even though programmes are negotiated mid-year and in effect running for less than twelve months. The second issue is the validity of a 0-1 dummy variable for the absence and presence of IMF programmes during simulation exercises. The use of a binary one-zero index does not mirror implementation of programmes. Programmes may also be scheduled at 6-month frequencies and waivers may be granted to permit purchases even when implementation slips. A third problem is related to the implementation of World Bank programmes simultaneously with IMF programmes and the attempt to disentangle the separate effects of each (Dicks-Mireaux *et al.*, 2000). The effects of IMF programmes must not necessarily follow a linear path, and improvements in some variables may be offset by decline in others, which cannot be captured by a simple search for percentage increments in target variables (Bird, 2001). Empirical studies report that there is a clear trade-off between growth and the current account (Baqir *et al.*, 2003).<sup>2</sup> Besides, an assessment of programme impact is precisely an evaluation of the IMF's as well as the in-country policy maker's knowledge of the

economy. Forecasting and programme design necessitates understanding of financial programming, both the accounting frameworks, but most importantly the behavioural relationships. Such full perceptive reasoning is highly unlikely, where accurate data problems and analyses exist, particularly in low-income economies. The negative impacts of IMF programmes are inherent policy design and discovery of these is hardly an accomplishment.

Other methodological issues are related to implementation. A number of studies have also found that compliance with IMF conditionality have been problematic and a significant proportion of programmes have not been completed casting doubt on the value of the impact assessment (Killick, 1995a; Mussa and Savastano, 1999; and Bird, 2001). The results show that out of the 305 programmes studied 53 per cent were uncompleted. At a more disaggregated level 50 per cent of Stand-by arrangements, 85 per cent of EFFs and 38 per cent of SAFs were uncompleted (Killick, 1984a and 1995a). Conway (1994) also finds that 50 per cent of programmes were uncompleted, while Mussa and Savastano (1999) find 34.8 per cent of IMF programmes were interrupted. Earlier, Edwards (1989) showed that 50 per cent of fiscal and monetary targets for policy instruments were not complied with. The results also indicate that most of the programmes were uncompleted in Africa and Latin America. The IMF, however, insists that programmes failures are related to political disruption and fading commitment (IMF, 2001a). Similarly, a recent study by IMF staff members stated that ethnic fractionalism, linguistic divisions, special interest groups, and lack of political unity cause programme interruptions (Anayiotos, *et al.*, 2001).

Despite the findings that programmes do not work and there is no catalytic effect of IMF credit, the IMF continues its lending, particularly to existing borrowers, what is commonly known as “recidivism” (Bird, 2001). Repetitive IMF lending has been the practice particularly in countries with low growth, balance of payments crisis, high inflation, overvalued exchange rate, primary export dependence, and high debt burden (Edwards and Santaella, 1993; Conway, 1994; Knight and Santaella, 1997; Conway, 2000; Bird *et al.*, 2002; and Joyce, 2002). This implies that new programmes are implemented to reverse previous failures of same type of

programmes, leading to a vicious circle of IMF lending and economic decline. This is explained by political and institutional factors that reinforce the supply of and the demand for IMF loans. These are related to IMF's wish to assert its position, manifested by increases in its staff size and resources (Vaubel, 1994 and Willet, 2001). It has also been found that a member country's political stance that conforms to that of the IMF or the United States determines the probability of loan approval (Thacker, 1999 and Barro and Lee, 2001), what is called the "political proximity hypothesis". On the other hand, governments seek IMF leading in the aftermath of political elections, mainly as they gain political legitimacy to push through unpopular reforms (Przeworski and Vreeland, 2001). Similarly, governments adopt IMF programmes to gain external political and financial support to fend off local political opposition (Vreeland, 1999 and 2001; Drazen, 2001 and Mayer and Mourmouras, 2002).

There are some important issues that emerge from the impact literature. First, the continuous search for the counterfactual diverts the fundamental problem of development. The counterfactual is clearly a situation where the terms of trade remain unfavourable. An impact assessment would be instructive if, rather than measurement of short-term financial relief, it deals with the fundamental causes of economic decline and how these have been resolved. Second, the studies report success and failure on the basis of statistical significance or otherwise. Significance tests based on t-statistics do not tell us much about economic significance in terms of concrete development outcomes such as improved standard of living or structural transformation. Third, the impact studies tell us nothing about the cost of improvement in the rate of growth and the balance of payments, as these are often achieved by severe deflation. The short run damage may have a longer than expected effect on productive capacity. Fourth, it is a disappointment that the impact analysis has not been taken seriously either in developing a complete methodology or as a response to criticism of IMF programme or as a way of feedback to policy formulation. To use a medical metaphor there is no feedback from results of treatment to new or continuing patients.

The rest of this Chapter is organised as follows. Section 4.2 examines the methodological difficulties in capturing the impact of IMF programmes. Section 4.3 reviews the empirical evidence, which uses the before-and-after technique. Section 4.4 reviews the empirical evidence, which is based on the with-and-without methodology. Section 4.5 reviews the empirical evidence, which uses the modified with-and-without technique and discusses the remaining biases in the methodology. Section 4.6 surveys the results from studies, which use multiple regression and structural model approaches, while highlighting major deficiencies of these techniques. Section 4.7 reviews the evidence from studies, which employed the actual versus target approach. Section 4.8 discusses studies, which examine how IMF programmes are actually implemented. Section 4.9 reviews studies that look into the determinants of the supply of and demand for IMF programmes. Concluding remarks are provided in Section 4.10

## **4.2 Why We Don't Know Whether IMF Programmes Work or Not**

As shown in the previous chapter, proponents of stabilisation and adjustment programmes argue that IMF policies work, while there is no theoretical case to do so. Empirically, the major issues in assessing the effectiveness of stabilisation and adjustment programmes are set out in Guitian (1981) and Williamson (1983c). The problem of measuring the counterfactual (i.e., what would have happened in the absence of IMF programmes) is one of the most important aspects addressed in the literature. If the counterfactual is known it would be easier to answer the question “do IMF programmes work?” As Williamson (1993c) notes the positive and negative effects of stabilisation and adjustment programmes must be evaluated against the potential outcome and the counterfactual “in which case one would not be justified in giving either a blanket endorsement or an outright condemnation of Fund performance.” (p. 132). Krueger (2000) also adds that:

“Hardship endured after the start of a Fund programme are generally blamed on the programme, without regard to the counterfactual trajectory of economic variables that would have occurred had there been no Fund programme and the economy continued its downward spiral” (p. 12).

Since the counterfactual is unobservable and impossible to measure directly, the consensus is to identify a methodology that allows its closest approximation. But the problem remains unresolved, as one cannot compare the approximation with the counterfactual, which is not known in the first place. Given this conundrum a number of studies employed methodologies, which included the before-after, the with-without (also referred as the Control-Group), the modified with-without (or GEE), the multiple regression/structural model, the actual vs. target approaches, individual country case studies as well studies to determine programme continuity, compliance and sustainability. Most of these studies employ standard statistical tests and econometric simulations using cross-section data set. The standard measure of performance is to evaluate the changes in target variables.

### 4.3 The Before-After Approach

The before-after approach looks at the period before the implementation of programmes as what would have happened in the absence of programmes or as a measure of the counterfactual. Implicit in this approach is the assumption of *ceteris paribus*, that is the difference between the pre-programme and programme period is the implementation of the programme but nothing else. The major shortcoming of this approach is that it ignores exogenous factors such as changes in the terms of trade and international interest rates that affect macroeconomic performance. If, for instance, the terms of trade were deteriorating in the pre-programme and improves in the programme period, it is likely that studies which compare the before and after changes in target variables will overstate the true effect of the programme and vice versa.

#### 4.3.1 Empirical Evidence from Before-After Studies

The earliest study that applied the before-after approach is that of Reichmann and Stillson (1978), which tested non-parametric statistical significance of changes in policy instruments (expansion of overall credit and credit to the public sector) as well

as changes in net foreign assets (or the balance of payments), prices and economic growth, between one year before and after the programme periods. Non-parametric tests are used when the data is not normally distributed and non-parametric tests determine whether the values of an observation from one group are significantly lower than the observation from the other group. The authors used quarterly data for the period 1963-72 and looked at 79 programmes under the IMF upper credit tranche Stand-by arrangements.<sup>3</sup>

The results show that in 29 out of 79 cases there were reductions in the growth rate of overall domestic credit. Similarly there were reductions in the growth rate of credit to the public sector in 36 out of 79 cases. Improvement in the net foreign assets was registered only in 24 per cent of cases.<sup>4</sup> As far as the results for prices concerned, the change was insignificant: in 7 cases there were decreases, in 6 cases increases and no change in 16 cases. The effect on GDP was also inconclusive. In 28 cases there was a decline, in 33 cases an improvement and no change in 9 cases. Reichmann and Stillson (1978, p. 303) note that according to the results, in the short-term, there is "[N]o evidence that programmes systematically affected the level of economic activity within the periods considered." In a similar study, Reichmann and Stillson (1977) obtained similar results and concluded, "most of the unsuccessful programmes failed because of fiscal problems and, in particular, because the limits on credit to the public sector were exceeded" (p. 25).

Killick (1984a) also used the before-after approach to evaluate the effect of IMF programmes. The data are based on 38 programmes agreed between 1974-79 with non-oil developing countries and effects were studied for both one and two years before and after programmes.<sup>5</sup> The study used the non-parametric method to observe the significance of changes in the rate of growth of GDP, the rate of inflation, current account, international reserves and domestic credit and the money supply. The results obtained by Killick indicate that in the first year there was a decrease in total domestic credit, but it disappeared in the following year. On the target variables there was an increase in the current account deficit and a fall in international reserves, while the overall balance of payments remained constant.<sup>6</sup> The results on the impact of IMF programmes on economic growth imply an improvement in the first year, but not in

the second. The results on the inflation rate also indicate a deceleration in the first year but acceleration in the second.<sup>7</sup> The impact of programmes on income distribution is also studied but no conclusive evidence is obtained as to the positive or negative outcomes.

Zulu and Nsouli (1985) have compared achievements against the previous year performance for 22 African countries under 35 Stand-by and EFF arrangements for the period 1980-81. Their results indicate that the rate of economic growth declined in most and the rate of inflation worsened in half of the countries. The current account and the overall balance of payments as a proportion of GDP did not improve for most. No change was reported in savings and investment as a proportion of GDP. Instruments such as government expenditure as a proportion of GDP declined or remained unchanged while government revenue increased in most cases. Net growth of credit to the government declined or remained unchanged while credit to the private sector was exceeded in most cases. External debt ratio as a proportion of GDP is reported to have increased in all cases.

Pastor (1987), on the other hand, analysed the effect of IMF programmes on income distribution to investigate whether programmes redistribute income away from the less powerful class to the elite. The argument is based on the theory that redistribution of income is determined by whether labour or capital is the dominant means of production, who benefits from a fall or rise in the growth rate and the relationship between the propensity to save between classes. Pastor looked at 18 Latin American countries under IMF upper credit Stand-by arrangements covering the period 1965-81. The methodology employed both absolute and relative comparisons, that is one year before and after and the with-without approaches (results for the later methodology are discussed in the following section). In both cases parametric and non-parametric significance tests were applied.<sup>8</sup> The variables studied are the balance of payments, the current account, the rate of inflation, the rate of growth, dependency measures and labour's share of income.<sup>9</sup>

The results for the absolute changes between pre-programme and post-programme periods are summarised as follows. Growth and the current account ratio



did not improve, while the overall balance of payments improved at 0.598 and 0.055 significance levels respectively. Inflation is reported to have accelerated in the programme period where no evidence was found for the stagflationary effect of programmes. Exports as well as imports rise during programmes compared to the previous period. Most importantly, the labour share of income falls during the programme period at 0.040 significance level. The last result supported the argument advanced by Pastor (1987) that the cost of stabilisation and adjustment programmes are borne by the working class as wages are restrained, prices liberalised, subsidies reduced and import prices increased due to devaluation. Pastor also argues that the elite in society are taken into consideration in the design of programmes and protected from the costs. The results confirm the proposition that IMF programmes redistribute income away from workers to capitalists. As local elites gain the surplus and increase their profitability, foreign capital is attracted, but this “paints a rosy picture of balance of payment improvement, but beneath lies worsening income distribution, exacerbated social tension, and little or no improvement in the inflation, current account, and growth fundamentals” (p. 259).

Khan (1990) employed the before-after methodology in his study of 69 countries under upper credit tranche arrangements over the period 1973-88. For programme countries, 315 observations were collected. The target variables under study are the balance of payments, current account balance, inflation and growth. The results for the one-year before and after comparisons indicate that there appeared to be a substantial improvement in the current account. Progress is also achieved in the case of the overall balance of payments and the rate of inflation but the coefficients are insignificant. The rate of growth fell in the programme year but the coefficient was also statistically insignificant. Khan concludes that on “the basis of standard statistical criteria however, it would appear that programmes lead to an improvement only in the current account position” (p. 213).

Schadler *et al.* (1993) looked at the experience of 19 (15 are African) countries under the ESAF arrangement between 1987-1992.<sup>10</sup> The target variables under study are the rate of economic growth, balance of payment “sustainability” and structural change. The before-after approach is used to assess whether the objectives are met or

not in SAF/ESAF compared to pre-SAF/ESAF period. The study did not test for statistical significance and simply compared the means and medians in the target variables before and after the implementation of the programmes. The authors also argue that the success of post-SAF/ESAF period must be compared against the unfavourable initial conditions due to, for example, the deterioration in the terms of trade. This point, however, is later contested by Killick (1995a, p. 83) as only 2 of the 19 countries adopted IMF programmes for the first time: "[I]t is only partial exaggeration to say that the before-after comparisons in OP106 are testing whether SAF-ESAFs work better than Stand-by arrangements. Unfortunately, the report is too flawed to permit a conclusion on this."<sup>11</sup>

The results reported by Schadler *et al.* (1993) indicate that 11 countries out of the 19 moved closer to balance of payments "viability", while for the remaining 8 progress was constrained by rising debt ratios and interest payments. The 11 countries that moved to balance of payments viability have also had an increase in real GDP, and exports as well as a reduction in the rate of inflation. For the whole sample real GDP growth rate averaged 4 per cent and 3 per cent during the SAF and ESAF period, respectively, compared to 2 per cent in pre-SAF/ESAF period. Similarly, the rate of inflation fell, savings and investment as a proportion of GDP and the level of international reserves improved. The only negative result obtained is the worsening of the current account deficit, which is attributed to the deterioration in the terms of trade.<sup>12</sup> In sum, "[L]argest improvements in macroeconomic performance occurred in countries that undertook the most *forceful reforms* and suffered the least from weakening terms of trade" (p. 39, italics added).

Killick (1995a) also uses the before-after approach to examine the effects of IMF programmes on 16 developing countries covering the period 1979-1985. The main variables under study include balance of payments, inflation, economic growth and total absorption. The study deals with three comprehensive issues. It attempts to look at the sustainability of programmes up to four years; tests whether programme completion/non-completion makes any difference; and tests whether implementation of another programme, just before the new programme under observation, influences outcomes or not.

The results indicate that the effect on the balance of payments was positive and significant especially the current account for countries, which completed programmes.<sup>13</sup> But the evidence on the catalytic role of the IMF is weak: the “*average net effect is a reduced capital inflow*” (p. 71). The results also indicate that 40 per cent of programmes were characterised by an increase in the rate of inflation even in the long-term. As regards the rate of growth, the results are weak whether the programmes are completed or not. The effect on absorption is summarised as follows: in the “absence of any strong catalytic effect, absorption has to be reduced relative to GDP if the balance of payments is to be strengthened. That programmes are associated with such a reduction is among our strongest results, with substantial and significant changes over the entire post-programme period” (p. 72). Finally, the results show that countries’, which had implemented programmes, immediately after another programme is completed, fared well in balance of payments and current account improvements. On the other hand, countries with no previous programmes in place saw a reduction in total absorption and particularly fixed investment, domestic credit and imports in the first year of the programme.

#### 4.4 The With-Without Approach

The approach in the with-without or control-group method is a comparison of countries with stabilisation and adjustment programmes and those without. The basic idea is to estimate the counterfactual in programme countries by the macroeconomic outcomes observed in non-programme countries. This approach overcomes the problem in the before and after technique, that is both programme and non-programme countries are selected under the assumption that both groups face the same external environment. This makes possible distinguishing programme from non-programme effects on target variables. This indicates that the bias in the before and after approach is removed, although at the cost of introducing a new source of bias, which is the characteristics of non-programme countries (Goldstein and Montiel, 1986).

The drawback of the traditional with-without approach is the failure to control for systematic differences between programme and non-programme countries. Since

programme countries are likely to have identical macroeconomic difficulties, for instance, suffer from an unsustainable current account deficit, the selection represents a non-random sample. This is the famous problem of sample selectivity-bias. In this case, any improvement during or after a programme is likely to be overstated or vice versa. This difference exists as long as determinants of programme selection are correlated with non-programme factors that determine the change in the target variables in the absence of programmes.

#### 4.4.1 Empirical Evidence from With-Without Studies

Donovan (1982) used the with-without approach in his study of 35 countries under 78 upper credit tranche Stand-by arrangements with the IMF for the period 1971-1980.<sup>14</sup> The study observes the changes in the current account, rate of inflation, rate of growth, savings, investment and real consumption in programme countries.<sup>15</sup> The study also looks at changes in variables both at one and three years before and after the implementation of programmes and compares the figures with the performance of non-oil developing countries (NODCs). The results show that the current account and the balance of payments performance for programme countries were better than NODCs. As regards inflation, programme countries performed better only in the long-term. The effect of stabilisation policies on growth is found to be neutral. This point was qualified by Donovan (1982, p. 196): “[A]s regards the rate of economic growth, the evidence does not support the hypothesis that there was any significant downward bias in the performance of programme countries. By and large, performance seemed overall to be associated with a broadly neutral outcome, insofar as the economic growth variable was concerned.” Since growth was not affected, the study concludes that the increase in savings was not at the expense of real consumption. Similarly, the decline in the ratio of investment to GDP is interpreted as increases in productivity.

Loxley (1984) conducted an empirical study to examine the performance of 38 least-developed countries (LLDCs) under IMF programmes between 1971-82. The study defines LLDCs as countries with per capita income of \$690 or less in 1980.

Loxley's objective was to test the applicability of Donovan's results to LLDCs.<sup>16</sup> The results show that for LLDC programme countries the ratio of current account balance to GNP on average declined by 0.4 and 2.6 per cent on both the one-year and three-year measures, respectively. For all LLDCs the ratio fell by 0.9 and 2.2 per cent, respectively. For Non-Oil Developing Countries (NODCs) the ratio declined by 0.4 and 0.8 per cent in both one and three year measures, respectively. The overall conclusion is that the performance of the current account for LLDCs was well below Donovan's programme countries in both one-year and three-year measures. Compared to all LLDCs the performance of the current account was better on one-year and worse on three-year measure.

As regards inflation, LLDC programme countries performed better than Donovan's programme countries. For LLDCs the rate of inflation changed by 0.4 and 0.2 per cent in one and three year measures, respectively. On the performance of growth Loxley (1984, p. 15) concludes that the "growth performance of LLDC programme countries as a whole seems to support Donovan's argument that there is no evidence of either sharp contractions or sharp increases in growth rates." For LLDCs the change in the growth rate was -0.2 and -0.5 and for Donovan programme countries the change was -0.3 and -0.4 on the one-year and three year measures, respectively.<sup>17</sup> The significance and conclusion of Loxley's study is that no major difference was detected between the performance of LLDC programme countries and all LLDCs with 95 per cent confidence level. Similarly, the performance of LLDCs under upper-credit tranche was not significantly different from those under Stand-by arrangements. Loxley argues that Donovan obtained favourable results due to the composition of his samples, which included "major exporters of manufactures" and "net oil exporters" (Loxley, 1984, p. 27).<sup>18</sup>

The results obtained by Pastor (1987) were discussed in the previous section under the absolute comparisons. The results for the relative comparisons between programme and non-programme countries indicate that the overall balance of payments improved for programme countries while the change in the current account was insignificant. These results confirm the proposition that the balance of payments improve due to the capital rather than the current account. This is the result of the

capital account showing the “catalytic” effect of IMF programmes or as Pastor argues the “debt trap”. It is found that inflation accelerates for programme countries while no evidence was found to support the argument that programme countries fared worse in terms of growth than non-programme countries. As regards the dependency measures an increase was seen in programme countries and labour share of income declines or rises in slower rates compared to non-programme countries.

Gylfason (1987) also uses the with-without approach in his study of 32 countries under upper credit tranche Stand-by arrangements. The year 1977 is the pre-programme period, 1978 the programme period and 1979 post-programme period. The basic methodology consists of non-parametric statistical tests of significance of the differences in the outcomes of target variables between programme and non-programme countries (or the reference group). The theoretical underpinning in Gylfason's study does not only focus on the effect of changes in domestic credit on demand but also on supply: credit is taken as working capital and the interest rate as its cost. In other words, credit policy is part of a production function.

Gylfason evaluates the changes in target variables for programme countries over the years 1977, 1978 and 1979 before comparing them to non-programme groups. The results show that during the programme year (i.e. 1978) domestic credit as well as money supply fell significantly. As a result both the overall balance of payments and the current account improved. The interesting result is that output growth remained unchanged. Gylfason criticises Donovan's (1982) country composition and chose to compare programme countries with non-oil developing countries that had a current account problem between 1975-1977. The fall in the domestic credit and the improvement in the balance of payments were statistically significant while no significance was found on the changes in the growth and inflation rates. Gylfason (1987, p. 28) states that the “direct negative effects of credit restraint on output growth were apparently offset by other factors such as devaluation or structural adjustment. It thus appears that the experience of these Stand-by arrangements does not give occasion for grave concern about the short-term contractionary or even stagflationary consequences of adjustment programmes supported by the Fund.” (p. 30).

Khan (1990) has also carried out an empirical investigation using the with-without approach. The data and the period of analysis remain similar to that of the before-after approach discussed in the previous section. The only addition is the 789 observations for non-programme countries. The results show that the performance of programme countries in terms of the current account, overall balance of payments and inflation was better than non-programme countries. In the case of economic growth, it is reported that programme countries achieved progress relative to non-programme countries. However, this result was found to be statistically insignificant.<sup>19</sup>

#### 4.5 The Modified With-Without Approach

As mentioned above the major shortcoming of the traditional with-without approach is that it does not take account of systematic differences between programme and non-programme countries. This sample-selectivity bias is removed if either the programme group is selected randomly or the correlation between the determinants of programme selection and the outcomes in the counterfactual are separated. If not, the real impact of IMF programmes will not be known. The modification is to obtain unbiased estimates of IMF programme effects in the face of non-random selection of programme countries. The technique is to control for *observable* differences between programme and non-programme countries. Goldstein and Montiel (1986) formulated a simultaneous model for modification of the traditional approach. The technique acquired from the literature on labour training evaluation, commonly known as the General Evaluation Estimator (GEE), incorporates exogenous factors that affect macroeconomic outcomes. Its special feature is that it introduces a policy reaction function and a function that determines the probability that a country adopts stabilisation and adjustment programmes. The policy reaction function models the determinants of macroeconomic policy changes initiated by the authorities in the absence of programmes. While Corbo and Rojas (1992) and Bagci and Perraudin (1995) use instrumental variables, and Garuda (2000) introduces “propensity score estimation” method to correct sample-selectivity bias.

The modified approach also has some limitations. As Goldstein and Montiel (1986, p. 322) acknowledge they only “control for observable differences between programme and non-programme countries. Sample-selectivity bias would remain because of unobservable differences between programme and non-programme countries.” Moreover, since countries implement IMF programmes because they experience macroeconomic problems, those countries that are not implementing such programmes can hardly be a good measure of the counterfactual (Krueger, 1998b).<sup>20</sup> The modification fails to capture the decisions, which determine to adopt IMF programmes. This is because a loan recipient country’s decision to adopt IMF programmes and the IMF’s position to lend are correlated with the downturns in the country’s economy. The assumption that macroeconomic policy choices can be easily formulated in a simple reaction function with available data and that the counterfactual can be estimated for non-programme countries by the reaction function is too simplistic. According to Garuda:

“This process of “balancing” programme and non-programme observations by propensity score controls for systematic differences between the two groups prior to the decision whether to participate in a Fund programme. In particular, countries seeking the Fund’s assistance typically face an unstable pre-programme economic climate than those who do not. Failure to control for these pre-programme differences would bias our measures of the Fund’s impact.” (p. 1032).

#### 4.5.1 Empirical Evidence from the Modified With-Without Studies

Goldstein and Montiel (1986) use the modified model to examine the effects of 68 IMF programmes on 58 developing countries under Stand-by as well as EFF arrangements over the period 1974-81 with 397 observations. The study calculated the before-after changes in the target variables in programme countries and compared the results with the changes in non-programme countries, while testing statistical significance. The target variables under study are the current account, the balance of payments, and economic growth. The policy instruments are total domestic credit and real effective exchange rates. The evidence shows worsening current account, balance



of payments and growth performance for programme countries. Goldstein and Montiel argue that the above results support their expectation that the traditional with-without approach provides a biased estimate of programme effects. The test of pre-programme difference between programme and non-programme countries appeared positive: the “difference between programme and non-programme countries was the single most robust empirical finding of our tests” (p. 335). Although the authors point out that the modified estimators are far from perfect, they went on to say: “[W]e have, however, demonstrated that point estimates of programme effects are not robust when variables are included that measure the pre-programme characteristics of countries, and that the direction of change in estimated programme effects is as expected a priori” (p. 338).

Khan (1990) also estimates the effect of IMF programmes using the modified approach or the GEE. The dependent variable is a vector that consists of changes in the current account, balance of payments, inflation and the rate of growth. The independent variables include one period lagged target as well as instrumental variables and variables that represent external factors.<sup>21</sup> The results for the GEE show an improvement in the current account, the overall balance of payments and inflation but a decline in the growth rate relative to non-programme countries in the short-term. The results also show that the long-term positive effects on the current account and inflation become stronger and the negative effects on growth lessened.<sup>22</sup> This contrasts with the results obtained from the traditional with-without approach, which provides a biased estimate of programme effects.<sup>23</sup> Khan also investigated macroeconomic and growth stability and differences in the effect of IMF programmes between the 1970s and 1980s. The results show negative relationships between inflation, the real exchange rate and growth, on the one hand, and a positive relationship between fiscal deficits and growth, on the other. On the performance of growth, the 1970s were found to be no different from the 1980s.

Corbo and Rojas (1992) also use the modified approach to estimate the effect of adjustment policies in 77 developing countries for the period 1970-88.<sup>24</sup> The idea is not to compare and contrast programme with non-programme countries but to use the latter group's performance as the counterfactual scenario. The variables under study are the rate of growth of GDP, the ratios of gross domestic saving, investment and

total exports to GDP. Corbo and Rojas argue that the traditional equation provides a biased estimate of programme effects because the variable that determines programme selection (i.e. the dummy variable) is endogenous. Thus, they attempt to solve such selectivity-bias by using an instrumental variable.<sup>25</sup> The results show that under the traditional with-without approach only the rate of growth of GDP appears to have improved during 1985-88 compared to 1970-80 and 1981-84. The coefficients for the other variables were insignificant. Under the modified approach however, it was found that programmes resulted in significant increases in the rate of growth and the ratio of exports have significantly improved relative to the previous two periods. In the case of savings, improvement was shown in 1985-88 compared to 1981-84 period, but it was insignificant compared to 1970-80. The results for investment indicate a 3.5 percentage decline between 1970-80 and 1985-88, but the change between 1981-84 and 1985-88 was not significant. Corbo and Rojas (1992, p. 33) state that the "impact of the programmes on investment should, however, be interpreted carefully. Since adjustment is not estimated to have reduced growth, it must have increased the average efficiency of investment and utilisation of capital."<sup>26</sup>

Bagci and Perraudin (1995) argue that "self-selectivity" bias can be eliminated if the decision to adopt programmes is put into a formal model and use full Maximum Likelihood methods for estimation. The model is used to test IMF programme effects in 68 countries under Stand-by and EFF arrangements during 1973-92. The target variables under study are the balance of payments, the current account, inflation and GDP growth. The policy instruments include the budget surplus and domestic credit. The results indicate that under the traditional with-without approach (without selectivity adjustment) the performance of programme countries in terms of the balance of payments and the current account were better than non-programme countries. The reduction in the inflation rate and improvement in the growth rate were found to be insignificant. Under the modified estimates (with selectivity adjustment) significant improvements were shown in the balance of payments, the current account, and the rate of growth for programme countries relative to non-programme countries. Bagci and Perraudin suggest that these results are sustained up to two years after programmes and conclude, – "ignoring selectivity effects tends to suggest that although programmes result in improvement in target variables, these are not

significantly different from the performance of non-programme countries. Our results show that without the adjustment for self-selection, the *benefits* of [IMF] programmes are actually *understated*.” (p. 12 italics added).

Dicks-Mireaux *et al.* (2000) estimate a similar model to that of Goldstien and Montiel (1986) for 61 ESAF implementing countries over 1986-1991. The study took the growth rate of real GDP, consumer price inflation, and the ratio of debt to exports as target variables. The policy instruments included the deficit of the central government in relation to GDP, the growth of net domestic assets of the banking system, and the change in the nominal effective exchange rate. The authors support the choice of the ratio of external debt to exports as a measure of external viability because a significant number of economies in the sample approached the IMF with large debt burdens. The instruments included in the model are central government deficit in relation to GDP, the growth of net domestic assets of the banking system and the change in the nominal effective exchange rate. Dicks-Mireaux *et al.* find that IMF programmes have a positive statistically significant impact on growth and the external debt/service ratio, but not inflation. The impact was statistically significant with respect to growth at the 5 per cent level and the external debt/service ratio at the 10 per cent level.

## 4.6 The Multiple Regression and Structural Model Approaches

The multiple regression approach is the use of a single or simultaneous system of equations in a standard dependent-independent variable model. Usually the choice of independent policy variables and expectations of the signs on the coefficients are determined by the theoretical framework in which the model is tested. The regressions for the impact study always follow a statement of theory or hypothesis. The hypotheses often tested are those set out in the previous chapters, which, for instance, stipulates that the current account will improve due to exchange rate devaluation; reduction in government fiscal position improves the balance of payments etc. Then, the econometric model is specified to test the hypotheses. The basic model can be specified as equation 4.79.

4.79

$$\Delta y_t = \beta_0 + \beta_1 x_t + \theta_t$$

Where  $\Delta y_t$  is a vector of target variables;  $x_t$  is also a vector of instrument variables;  $\beta_0$  is a constant and  $\beta_1$  is a coefficient for each instrument variable and  $\theta_t$  is an error term. Depending on the theoretical underpinning of the model, additional instrument variables, for instance, the initial level of target variables, lagged instrument variables and dummy variables can be included.

Similarly, regression approaches have been incorporated in structural models used in evaluating adjustment programmes is associated with the work of Khan and Knight (1981 and 1985). The simultaneous structural regression model relates specific policy instruments to targets and consists of five behavioural equations (inflation, balance of payments, government sector, real income and inflation) and three identities (domestic credit, money supply and real money balances).

According to IMF (2001a) the confounding problem in the before-and-after approach can be eliminated through regression estimation; first, by estimating the economic model and policy reaction function of the participating country and during the IMF programme; or second, by pairing programme countries with non-programmes countries and attributing differences in performance to IMF programmes. The disadvantage is the model indicates neither performance nor outcome of programmes (Khan, 1990). Firstly, it does not explicitly assess the effect of programmes and only shows statistical relationships between target and instrumental variables. Although econometrics provides the tools used in estimating coefficients and forecasting changes in variables, it is not clear how impact of programmes is measured. In a widely taught textbook in econometrics it is stated that the “key idea behind regression analysis is the statistical dependence of one variable, the dependent variable, on one or more other variables, the explanatory variable” (Gujarati, 1988). The multiple regression models used in impact analysis, however, do not make clear whether the test is on statistical dependence, or on the goodness of the macroeconomic model or the hypothesis concerning the country. Secondly, it still has

the problem set out in the Lucas critique that the coefficients econometricians estimate when computing macroeconomic models may not be constant if policy makers alter their policy: the models up to that point were wrong. This is because coefficients incorporate agents' knowledge about the way that policy reactions occur. So, if policy changes, it is possible that the coefficients will also change. The exercise becomes erroneous, as no parameter remains fixed. The critique is damaging especially to forecasting, because parameter constancy is imposed on macroeconomic models when deriving predictions (Lucas, 1976).

#### **4.6.1 Empirical Evidence from Multiple Regression and Structural Studies**

Using the structural model referred to above, Khan and Knight (1981) carried out a multiple regression exercise for 29 developing countries under IMF Stand-by arrangements covering the period 1968-75. The results indicate that for an average "representative" country a 10 per cent increase in the money supply increases output by 0.05 percent and reduces international reserves by the same amount as the monetary expansion. Similarly, a 10 per cent increase in capacity output leads to a rise in employment and real output and an initial decrease in the domestic price level by about 5.05 per cent in the first two years. The model incorporates financial variables and does not consider the effect of capital accumulation or wealth on long-term growth.<sup>27</sup> Khan and Knight (1985) construct another structural model slightly different from the 1981 variety and state, but does not focus on the effect of individual policy changes and the main concern is to show the effect of supply-side policies. The results show that if only demand-side policies are implemented, the growth rate of GDP declines in the first year and starts to rise in the second until the initial level is restored in the third year, inflation accelerates and the current account improves.<sup>28</sup> The most important conclusion of the structural simulation exercise is, therefore, not only that the combination of demand- and supply-side policies reduce the short-term cost of adjustment, but also that the overall package succeeds in putting the economy on a higher capacity growth and "raise the growth rate permanently by increasing secular growth path." (p. 23). The cost minimizing effect of supply-side policies as stated by Khan and Knight (1985) is as follows.

"The output *costs* can be *reduced* significantly if appropriate supply-side measures are introduced simultaneously with the demand-management package. Assuming that this supply-side policies raise investment and thereby the economy's trend growth rate of capacity output (in the present illustration by 0.5 percentage point a year), the actual growth rate would also start to rise" (p. 22 italics added).

Doroodian (1993) used a multiple regression model in evaluating the effect of IMF programmes on 27 programme countries compared to 16 non-programme countries under upper credit tranche Stand-by arrangements for the period 1977-83.<sup>29</sup> The target variables include the current account, rate of inflation and output growth. The instruments are the real exchange rate, the public fiscal position, the interest rate and the rate of growth of domestic credit. The results of the regression indicate that IMF programmes improve the current account significantly and inflation moderately. A regression of the same type of equation for non-programme countries reveals that programmes had no impact on economic growth that is different from non-programme countries. Doroodian also analysed the effect of each policy instrument and concluded that the interest rate was the most effective instrument followed by the unanticipated growth in domestic credit, the fiscal position and the terms of trade.<sup>30</sup>

Conway (1994) examines the effects of IMF programmes through control of external factors important in determining outcomes and comparing the remaining performance and policy records of programme countries with non-programme countries. The study uses a simulation model and covers the period 1976-1986 to examine IMF programmes in 74 countries. The estimation is based on a mix of cross-section and time series data. The target variables studied include growth, the current account and inflation. The policy variables include government consumption, the rate of growth of domestic credit, government deficit and the real exchange rate.<sup>31</sup> The results indicate that the current account and inflation improved, while growth fell for programme countries. The finding on growth, however, was statistically insignificant. The fall in the growth rate is attributed to a decline in the domestic investment ratio. The other findings show that both public and private investment fell, government expenditure declined and the real exchange rate depreciated. Conway (1994, pp. 381-382) notes that:

“Reduction in public expenditure is the most clearly differentiable policy response to participation in IMF lending programmes, and accounts for the significant impact of participation on the current account. That this reduction is centred in public investment expenditure during this period explains both falling investment and growth. It is surprising, however, that the monetary control and real depreciation conditions central to many IMF programmes do not lead to significant policy effects.”

The paper by Havrylyshyn *et al.* (1998) employs a simple regression model similar to the one found in the economic growth literature to investigate changes in rate of change of real GDP. The explanatory variables include: the inflation rate, structural reform index, government expenditure as a percentage of GDP, initial condition representing macroeconomic distortions, socialist development and related distortions, initial level of per capita income, the degree of industrialisation, and effectiveness of the legal framework. Havrylyshyn *et al.* investigate the factors that determine growth in 25 countries for the period 1990-97, in Central and Eastern Europe, the Baltic, and Russia, which are in transition. The paper found that structural reforms, macroeconomic stabilisation, and reduction in government expenditures have positive effects on growth. The authors also argue that the short-term “pains”, new buyer’s market and austere budget cuts that signal cutbacks in production during the initial years of reform, are outweighed by the long-term gains.

Recently Barro and Lee (2001) applied a multiple regression model to test for the impact of IMF programmes on economic growth by using the instrument-variable technique: the instruments being institutional and political variables such as the size of a country’s quota at the IMF, the size of the national staff at the IMF, and a country’s political proximity to the U.S. The use of this technique is to avoid parametric restrictions on the distribution of error terms in a typical multiple regression model. Using panel data for 130 countries over for the period 1975-2000, Barro and Lee (2001) found that participation in an IMF programme is associated with lower per capita growth.<sup>32</sup>

## 4.7 The Actual versus Target Approach

As the name indicates the actual vs. target approach compares actual outcomes in target variables to targets set by the IMF or domestic policy makers *ex ante*. Unlike the methodologies discussed above the actual vs. target approach does not focus on measuring the counterfactual. The limitations of this approach are the bias against the IMF because targets may not be achieved for example, due to incomplete programmes and unfavourable external factors. Similarly targets may be under- or over-predicted depending on the model and the forecasting technique used. The adequacy of the actual vs. target method is also doubtful, as targets may be unrealistic or inadequate. The moves from stabilisation to adjustment as well as the IMF's increasing interest in poverty may also mean proliferation of targets and instruments that encourage partial achievement. For instance, setting targets for reduction in the level of domestic credit and devaluation of the local currency by a certain percentage may fail to achieve an improvement in the balance of payments due to unfavourable terms of trade effect. However, if, at the same time, targets were set to the interest rate, privatisation, domestic price liberalisation etc., some of the objectives may be achieved justifying claim for success or incrimination for failure. An appropriate method would be a comparison of actual outcomes with the best possible outcome, although subjectivity is increased (Williamson, 1983c). Further work should take into account waivers granted by the IMF and modifications made to programmes, which significantly alter programme targets (Khan and Ul Haque, 1998). Krueger (2000) also remarks that;

“Macroeconomic outcomes are uncertain: unforeseen or unpredictable future events (such as the prices of key exportable commodities or the weather), unpredictable or unanticipated (in terms of timing as well as of magnitude) responses of consumers and producers to altered relative prices, serious strikes, and changes in the government, can all affect the speed of response” (p. 11).

### 4.7.1 Empirical Evidence from Actual vs. Target Studies

The earliest use of the actual versus target approach is that of Reichmann (1978). For the period 1973-1975, 21 Stand-by programmes for 18 countries were



examined. On the balance of payments, 7 programmes were considered successful. In 19 cases, the target growth was achieved. However, the impact on prices was undetermined. The conclusion arrived by Reichmann is that given the economic climate of the mid 1970s, the outcome of Stand-by programmes was satisfactory, "...most of them were able to arrest a worsening economic position and all of them prevented the crisis situation that would have developed had no programme been in effect" (p. 41).

Zulu and Nsouli (1985) have also compared actual outcomes with targets for the current account, balance of payments, inflation, economic growth, savings and investment for 35 African countries over the period 1980-81. Their result indicates that the rate of economic growth and the current account fell short of targets in most cases. In the case of the balance of payments half achieved targets while the results for inflation, savings and investment were close to targets. In most cases the ratio of government expenditure to GDP and the budget deficit exceeded the targets while government revenue was close to its desired level. Targets on net growth of credit to the government as well as the private sector were not met. In a majority of cases the external debt ratio as a proportion of GDP exceeded the target.

Table 4.1 Summary of Research on the Impact of IMF Programmes

Author and Type of Methodology	No. of Countries	Years Covered	Effect on Growth	Effect on CA	Effect on Prices
<i>Before and After Approach</i>					
Reichmann and Stillson (1977)	79 <sup>a</sup>	1963-72	No Effect	No Effect	No Effect*
Reichmann and Stillson (1978)	79 <sup>a</sup>	1963-72	No Effect	No Effect	No Effect
Killick (1984a)	38 <sup>a</sup>	1974-79	Negative	Negative	Negative
Zulu and Nsouli (1985)	22	1980-81	Negative	No Effect	No Effect
Pastor (1987)	18	1965-81	No Effect	Negative	Negative
Khan (1990)	96	1973-88	No Effect*	Positive	No Effect*
Schadler <i>et al.</i> (1993)	19	1987-92	Positive	Negative	Positive
Killick (1995a)	16	1979-85	Negative	Positive	Positive
<i>With and Without</i>					
Donovan (1982)	35	1971-80	No Effect	Positive	Positive
Loxley (1984)	38	1971-82	No Effect	Positive	Positive
Pastor (1987)	18	1965-81	Negative	No Effect*	Negative
Gylfason (1987)	32	1977-79	No Effect*	Positive	No Effect*
Khan (1990)	96	1973-88	Positive*	Positive	Positive
<i>Modified With and Without Approach</i>					
Goldstein and Montiel (1986)	58	1974-81	Negative	Negative	-
Khan (1990)	96	1973-88	Negative	Positive	Positive
Corbo and Rojas (1992)	77	1970-88	Positive	Positive	-
Bagci and Perraudin (1995)	68	1973-92	Positive*	Positive	Positive*
Dicks-Mireaux <i>et al.</i> (2000)	61	1986-91	Positive	-	Negative*
<i>Structural Simulation Approach</i>					
Khan and Knight (1981)	29	1968-75	Positive	Negative	Negative
Khan and Knight (1981)	29	1968-75	Positive	Negative	Negative
<i>Multiple Regression Approach</i>					
Doroodian (1993)	27	1977-83	No Effect	Positive	Positive
Conway (1994)	74	1976-86	Negative	Positive	Positive
Havrylyshyn <i>et al.</i> (1998)	25	1990-97	Positive	-	-
Barro and Lee (2001)	130	1975-00	Negative	-	-
<i>Actual Versus Target Approach</i>					
Reichmann (1978)	18	1973-75	Positive	No Effect	No Effect
Zulu and Nsouli (1985)	35	1980-81	Negative	Negative	No Effect

<sup>a</sup> Programmes, \* Statistically Insignificant Results

## 4.8 Are IMF Programmes Implemented As Agreed?

The impact analyses discussed in the previous sections mainly focus on *outcome* on target variables to assess the effect of IMF stabilisation and adjustment programmes.<sup>33</sup> At the same time other studies of crucial significance appeared related to *implementation* issues. Recently, Mercer-Blackman and Unigovskaya (2000) examined whether successful compliance with IMF conditionality by transition countries results in better performance on growth. The authors tested the hypotheses that commitment to reform will result in proper follow-up of conditionality set by the IMF which in turn results in better growth performance. They found a positive relationship between the index of compliance with performance criteria and growth. More specifically, 84 per cent of the countries that complied with performance criteria conditionalities experienced sustained growth.<sup>34</sup>

However, a number of other studies found that compliance with IMF conditionality has been problematic, rendering futile the results from analysis of outcome. A large proportion of programmes have not been completed due to violation of programme criteria, shortage of capital inflow, lack of political commitment, poorly designed programmes, and external conditions. Beveridge and Kelly (1980) looked at 105 programmes over 1969-78 and showed that fiscal and monetary conditionalities were met in 55 per cent of the programmes. Edward (1989) found that of the 34 programmes implemented over 1983-85, 50 per cent of fiscal and monetary policy instruments were not complied with. Polak (1991) studied 161 IMF programmes and found that credit ceilings were implemented in 78 per cent of standby agreements but only in 38 per cent of EFF programmes. Fiscal performance targets were adhered to in 62 per cent of standby agreements but only in 29 per cent of EFF programmes. Conway (1994) found that only 50 per cent of IMF approved credits were drawn, indicating incompleteness of programmes.

Killick (1995a) defines uncompleted programme, as a programme in which 20 per cent or more of the total credit agreed between the IMF and a country is undrawn. His results show that out of the 305 programmes studied over 1979-1993, 53 per cent

were uncompleted. At a more disaggregated level 50 per cent of Stand-bys arrangements, 85 per cent of EFFs and 38 per cent of SAFs were uncompleted. The results also indicate that most of the programmes were interrupted in Africa and Latin America. Killick (1984a) also evaluates the difference between Stand-by and EFF arrangements in affecting target variables. However, apart from a high propensity of programme discontinuity in EFF arrangements the impact on target variables exhibited no significant difference.

By defining interrupted programme as a programme in which 25 per cent or more of the total credit agreed between the IMF and a country is undrawn, Mussa and Savastano (1999) also show that only 34.8 per cent of IMF programmes were complete, out of the 615 programmes reviewed over 1973-1997. The disaggregated findings also show that only 39 per cent of Stand-by arrangements, 9.5 per cent of EFF's and 32.4 per cent of SAF/ESAF's were completed. Mecagni (1999) defines programme interruption as 6 months delay in programme reviews and found that 77 per cent of the programmes reviewed in 36 countries were interrupted. Edwards (2001) found that, of the 347 programmes agreed over 1979-1995, 60 per cent were fully complied with, while the IMF suspended 40 per cent of the programmes.

It is evident that a large proportion of programmes are not completed, while nearly all of the studies, which focused on outcome, assume that they have been completed. Among the studies reviewed here only Killick (1995a) explicitly took account of programme completion, but found that no statistically significant difference was found between completed and uncompleted programmes. Assessing the impact of IMF programmes without taking account of which countries complied with conditionalities or which completed programmes definitely provides confusing results. However, measuring programme incompleteness as the undrawn SDR balance fails to take account that countries may achieve targets quicker than previously forecasted. In this case the rational decision is not to draw the remaining IMF balances as it implies increased debt burden (Joyce, 2002). For instance, if a country borrows from the IMF on a three year loan agreement due to a temporary terms of trade decline, and if the terms of trade improves in the second year the country may not continue with the programme. On the other hand, countries may be allowed to

continue to withdraw from approved IMF credit, despite evidence that the programmes are not working. This is supported by the IMF's frequent actions to grant waivers and introduce modifications to programmes. These issues imply that either way programme outcomes would be overestimated or underestimated (Bird, 2001).

Nonetheless, the findings indicate that high rate of non-adoption is the norm and the reasons provided vary. Waivers and modifications as well as early success in meeting targets are few and far between to vindicate programme incompleteness. Non-adoption in the 1980s is attributed to negative external environment, such as unfavourable terms of trade (Edwards, 1989 and Polak, 1991). Higher percentage of programme non-completion in Africa and Latin America is due to structural weaknesses and the terms of trade effect in the former and the debt overhang in the later (Killick, 1995a). Given these factors, it was difficult to cut budget deficits and devaluation raised the local currency value of debt, hence failure to meet many of the targets specified under IMF programmes.<sup>35</sup> Mussa and Savastano (1999), in their review of 615 IMF programmes over 1973-1997, found that 37 per cent of the programmes were interrupted and disbursement not completed due to unanticipated external environment, but over 75 per cent of uncompleted programmes were due to the recipient country not meeting IMF conditionalities.

High rate of non-adoption is reported because conditionalities conflict with governments' capacity to implement policies and their wish to present policies as home-grown (Kapur, 2001 and Goldstein, 2000 and 2003). The IMF, although acknowledging non-compliance and conceding the need for "streamlining" its conditionalities and enhancing local ownership (IMF, 2001c), also insists "the data provide no indication that more conditionality impairs implementation" (IMF, 2001a, p. 21) and "implementation *rates* vary widely, but they are essentially uncorrelated with the extent of conditionality" (IMF, 2001b, p. 72). For the IMF "most programme interruptions have been the result of factors outside the funds control - that is, *major political upheavals and flagging commitment*" (IMF, 2001a, p. 56 italics added). Similarly, an IMF working paper stated, "ethnic and linguistic divisions, strong special interests, and lack of political cohesion contribute to programme failure" (Anayiotos, *et al.*, 2001, p. 2).

Another interesting finding of the impact literature is the absence of private capital flows following IMF programmes. The IMF argues its programmes have a “three pronged approach”, where stabilisation, adjustment and capital inflows ensure improved performance (IMF, 2001a). This is because IMF conditionality provides borrower credibility and signals reform commitment to private capital. However, empirical studies have shown that there is no evidence for the catalytic effects of IMF programmes, particularly private capital inflows (Rodrik, 1996b and Bird and Rowlands, 2001). The only effect observed is that private lenders may reschedule debt in response to IMF programmes (Edwards, 2000). The conclusion is that not only IMF programmes do not work both in terms of stabilisation and adjustment, but they also are not implemented fully and they also fail on the third aspect: no catalysis has been identified.

#### **4.9 Who Adopts IMF Programmes and Why?**

Despite these findings, there is an increasing flow of IMF credit and new programme arrangements both to new borrowers and existing clients, which is known in the literature as “recidivism” (Bird, 2001). The rate of repetitive lending remains high with a probable inference that new programmes had to be prescribed because earlier ones failed. Empirical work has confirmed “recidivism” through; first, lagged IMF programmes are significantly correlated with current programmes; and second, there is a strong link between economic downturn and adoption of IMF programmes. It has been found that repetitive lending is not associated with improved performance (Easterly, 2002). The data for SSA show that Cote d’Ivoire had 26 adjustment loans but per capita growth rates averaged –1.4 per cent, Ghana had 26 loans and an average growth rate of 1.2 per cent, Senegal had 21 loans and an average growth rate of 0.1 per cent, Uganda had 20 loans and an average growth rate of 2.3 per cent, and Zambia had 18 loans and average growth rate of –2.1 per cent. Conway (2000) studies 90 developing countries for the period 1974-1992 and concludes “the greater the time spent in preceding years in IMF programmes the lower the probability of ending the crisis in any period” (p. 4). Conway (2002 and 2003) shows that if an old programme

does not meet IMF conditionalities, a new one will have more stringent conditionalities or the programme will be suspended, depending on who has the greater bargaining power. Surely, repetitive lending negates the IMF's fundamental principle behind conditionalities that its funds are meant to rotate.

So the question becomes why the IMF continues lending and why the recipient countries adopt its programmes. In other words what determines the demand for IMF's resources and its supply?<sup>36</sup> This thesis classifies the literature into three schools, which deal with both supply of and demand for IMF programmes. These can be classified as the economic, the institutional and the political schools. For the economic school, IMF programmes are supplied and demanded because the recipient country faces low growth, balance of payments crisis, high inflation, overvalued exchange rate, and high debt burden (Edwards and Santaella, 1993; Conway, 1994; Knight and Santaella, 1997; and Mussa and Savastano, 1999).

For the institutional school, the IMF has an incentive to advance its loans to maximise its power and justify its existence. According to Kapur (1998) the "absence of rules designed to ensure self-restraint, its staff-like that of any other bureaucracy--will always push the fund toward policy prescriptions that give them greater prominence and influence" (p. 126). This has been manifested by increases in its staff size and resources (Vaubel, 1994 and Willet, 2002). The IMF is interested in power, prestige and amenities. To achieve these objectives the IMF maximizes its budget, staff, and conditionalities. This means that the IMF is not interested on who borrows as long as the recipient country meets simple criteria such as exchange rate liberalisation. The absences of eligibility criteria as well as imposing conditionalities *ex post* fail to solve moral hazard problems. Hence, the IMF suffers from bureaucratic efficiency and lack of external scrutiny (Vaubel, 1996). Moreover, it has been shown that the higher the quota of a country, it is more likely an IMF loan is advanced, and the larger the number of IMF national staff, the higher the probability of lending. These conclusions are based on "institutional and geopolitical" variables namely the size of members' quota, and the size of the national staff within the IMF (Vaubel, 1994 and Willet, 2002).

For the political school the determinants of supply of and demand for IMF programmes are political factors within the recipient country and around the large shareholders of the IMF, mainly the U.S. Empirical evidence shows that a member country's political stance that conforms to that of the IMF determines the probability of loan approval (Thacker, 1999). Using data for the years between 1975-1999 for 131 countries that agreed a loan with the IMF under Stand-by and EFF arrangements, Barro and Lee (2001) find that the nearer members' proximity to the U.S.-led political view, the higher the probability of lending, what is called the "political proximity hypothesis".<sup>37</sup> Recent studies also found that IMF decision-making creates an opportunity for U.S. policy makers to influence IMF lending. These are based on both interest group politics and foreign policy objectives. Loan disbursements between 1985 and 1998 were responsive to American pressure and larger loans went to countries in which American banks were highly exposed and to governments intimately allied with the U.S. (Oatley and Yackee, 2000). Internally, governments demand IMF resources in the aftermath of political elections, mainly because they gain political legitimacy to push through unpopular reforms (Przeworski and Vreeland, 2001). Similarly, governments adopt IMF programmes to gain external political and financial support to fend off local political opposition (Vreeland, 1999 and 2001). This is because introducing reforms is difficult where diversity includes political fragmentation, ethnic fractionalism, and political conflict. (Drazen, 2001; Ivanova, *et al.*, 2001; Mayer and Mourmouras, 2002).

The conclusion by all three schools can be used to explain why IMF programmes continue to flourish as well as their sustenance or abandonment. The economic school reinforces the view not only do economic crises determine first time IMF lending, but also repetitive lending to the same country as is the case in most countries (Conway, 2000 and Bird *et al.*, 2002). Repetitive lending is also linked to lower per-capita income, primary commodity exports, and landlockedness (Joyce, 2001). Institutionally, the IMF tolerates non-compliance for maintaining its own credibility due to large financial commitments as well as to protect international capital markets (Edwards, 2001). Programme interruptions do not occur in countries with large quota because these countries are too important to go off track, such as Korea (Joyce, 2003). This is consistent with the finding that most interruptions take



place in low-income countries. The political school confirms that countries closely allied with the U.S. face little threat of programme suspension (Stone, 2002). Joyce (2003) using data for 384 programme fully implemented in 77 developing countries over 1975-1999, find that government that stayed in power for longer period find adoption difficult as interest groups are solidified; and a government which is ideologically divided with each group having veto power find it difficult to adopt IMF programmes. Joyce (2003) also finds that open (trade and capital) economies adopt IMF programmes successfully than less open ones, while new and democratic governments find adoption easier.

#### 4.10 Concluding Remarks

By exploring existing methodologies, the purpose of this chapter has been to look into the impact of IMF stabilisation and adjustment programmes. Despite the explosion of these programmes in the last three decades, no conclusive evidence has been found as to their impact. The above survey of the available evidence indicates that less than 40 per cent of the programmes had positive impact on the growth rate, the current account and prices. This thesis finds that none of the studies comes to definitive conclusion, not to mention the methodological pitfalls. Several studies employed methodologies, which included the before-after, the with-without (also referred as the Control-Group), the multiple regression/structural model, the actual vs. target approaches, as well as case studies to determine programme continuity, compliance and sustainability, which found that more than half of IMF-programmes were interrupted in SSA and Latin America.

The major concern in the literature is measuring the counterfactual. The before-after approach is too simple to provide a detailed analysis of programme effects and approximate the counterfactual, mainly because it fails to take account of differences in the pre-programme and post-programmes periods. Similarly, the traditional with-without approach does not control for differences between programme and non-programme groups, which is referred to as sample selectivity-bias. Under the modified with-without approach some studies attempted to correct for sample and

selectivity-bias, but unobservable differences between programme and non-programme countries persist. The overall result indicates that there are no systematic differences between the pre-programmes and programme periods. Similarly, programme countries are not systematically different from non-programme countries. The multiple regression model approach, although providing a causal relationship between target and instrument variables, falls short of evaluating effectiveness of programmes. The studies based on structural models looked the mechanics of programmes without providing answers to success/failure. The methods used by the actual vs. target approach also produce mixed results at the same failing to consider difficulties involved in setting targets *ex ante* and achieving them in the face of external and internal shocks.

Some important issues are identified from the discussion in this chapter. The first problem is related to the problem of using annual data while IMF programmes start at any time of the year. The second is related to arbitrary use of 0-1 dummy variables for the absence and presence of IMF programmes. The use of a binary one-zero index does not reflect implementation of programmes. Programmes may be scheduled at 6-month frequencies and waivers may be granted to permit purchases even when implementation slips. Programme effects must not necessarily follow a linear path, and increases in some variables may be offset by decline in others, which cannot be captured by a simple search for percentage increments in target variables (Bird, 2001). One such finding is the trade-off between growth and the current account (Baqir *et al.*, 2003). Third, an assessment of programme impact is precisely an evaluation of the IMF's as well as policy makers' knowledge of the economy. Full grasp of economy-wide relationships is unlikely in the face of data problems and paucity of economic analyses, particularly in low-income economies.

Fourth, the attempt to find optimal values for target variables is futile simply because they are mutually inconsistent or there are "trade-offs" between them (Williamson, 1983c). As often seen in the empirical literature, the possibility of capturing individual country differences by aggregated cross-section analysis is problematic. Each country has a unique political characteristic, a distinct institutional makeup, and a particular policy mix. As Dicks-Mireaux *et al.* (2000) point out:

“First, an important question for the empirical application is whether individual country behaviour can be sensibly aggregated in a uniform model that is stable across countries and over time. Specifically, differing institutional characteristics (e.g., the degree of policy discipline inherent in specific exchange rate arrangements or the relationship with a major donor), changing political conditions, or varying severities of economic distress are likely to result in countries formulating different or changing constraints. Another question is whether it is appropriate to assume that the policy reaction function of a programme country, had it not received IMF support, is identical to that of a non-programme country that did not seek IMF support. For example, the counterfactual for a country receiving IMF support may involve the imposition of trade or exchange restrictions, while countries that do not seek IMF support may contain themselves to “IMF-type” policies; i.e., avoiding the use of trade or exchange restrictions” (p. 499).

Fifth, most of the findings base their criteria for success and failure on statistical significance, which does not necessarily mean economic significance. The success of IMF programmes cannot be vindicated by t-tests without explaining what their significance in real terms means. Significance tests based on t-statistics do not tell us much about economic significance. For instance, reduction in the level of domestic credit may have a statistically significant effect on reducing the current account. Similarly, an increase in the domestic rate of interest may have a statistically significant positive impact on savings. But these results do not tell us economic significance. The question is, are the improvements in the balance of payments and savings significant in the economic sense? In other words, do these improvements increase per capita income or the rate of growth or lead to structural transformation? The results reported above lag best practice as they neither show economic significance nor inform us how the conflicting results come about. The search for the counterfactual fails to address the fundamental problem of development. The counterfactual is plainly a situation where the terms of trade remain unfavourable. An impact evaluation would be informative if, rather than assessment of short-term financial relief; it addresses the fundamental causes of economic decline and how these have been resolved.

Sixth, the impact studies tell us nothing about the cost of improvement in the rate of growth and the balance of payments, as these are often achieved by severe deflation. The short run damage may have a longer than expected effect on productive

capacity. As shown in the previous chapters the IMF has extended its programmes from stabilisation to adjustment and structural issues. However, the impact analysis still focuses on programme effects on growth, current account and inflation. Improvements in these variables may be achieved with austerity, but there is no guarantee that the economies productive capacity has improved or not or whether there has been significant structural transformation.

It is a disappointment that the impact analysis has not been taken seriously as a way of feedback to policy formulation. The impact of IMF programmes seems to be that U.S.-friendly countries are locked into a vicious cycle of economic decline and IMF programmes, without any concrete development. Bearing the limitations and depending on the availability of information the case study approach is probably the most appropriate for application to a single country. Achievements and shortfalls in meeting targets can be explained by identifying special characteristics of a country by a case study, at a risk of failure to generalise lessons. This issue will be the main concern of the next two chapters, which will examine IMF programmes in Ethiopia and Uganda.

## Notes

<sup>1</sup> The issue of sample-selectivity bias is closely associated with the Nobel Prize winner James Heckman who pioneered a method for removing the bias in modelling wage determination in the labour market (see Heckman and Sedlacek, 1985).

<sup>2</sup> Baqir *et al* (2003) find no trade-off between inflation and the current account and between inflation and growth.

<sup>3</sup> Reichmann and Stillson (1978) observed the changes both at four and eight quarters before and after IMF programmes.

<sup>4</sup> The authors acknowledge that due to trade liberalisation a decline in net foreign assets is expected.

<sup>5</sup> Killick (1984a) argues that assessment of programme effects in one and two years is consistent with Stand-by arrangements and one can see the effect before exogenous factors develop. However Killick also notes one to two years assessment is not consistent with EFF and does not indicate whether the effect of programmes is sustained or not.

<sup>6</sup> The effect on the overall balance of payments is attributed to the catalytic effects of IMF programmes.

<sup>7</sup> A once-and-for-all increase in prices is expected in the short-term if price liberalisation is part of the programme.

<sup>8</sup> Pastor (1987) points out that although there is a danger of committing Type II error, one-tail test is used.

<sup>9</sup> Balance of payments and the current account are measured as a percentage of GDP, the rate of inflation as GDP deflator, dependency measures are exports plus imports as a percentage of GDP, and labour share is measured by labour's share of income in net GDP.

<sup>10</sup> Schadler *et al.* (1993) note that the "ESAF was designed to promote adjustment and reform in eligible countries by supporting particularly vigorous macroeconomic and structural change with a larger scale of resources on the same concessional terms as the SAF" (p. 1).

<sup>11</sup> OP106 refers to Occasional Paper No. 106, which is the same as Schadler *et al.* (1993).

<sup>12</sup> See Table 9 in Schadler *et al.* (1993) for a complete list of the results.

<sup>13</sup> See Table 3.5 in Killick (1995a).

<sup>14</sup> Out of the 35 countries 15 were from sub-Saharan Africa.

<sup>15</sup> Balance of payments is measured, firstly, as the ratio of current account balance to GNP/GDP in domestic currency terms and, secondly, as the ratio of the overall balance of payments to exports expressed in dollars. The performance of inflation is measured by changes in the rate of consumer prices. Changes in the rate of growth of GDP (at constant prices) are used to indicate the performance of growth. GNP measures the savings rate less aggregate consumption as a proportion of gross national income. The investment rate is

measured by gross fixed capital formation plus changes in inventories as a proportion of gross national income. Finally, real consumption is measured by aggregate consumption deflated by changes in the consumer price index.

<sup>16</sup> The differences in Donovan's and Loxley's approaches are: firstly, Loxley applied significance tests while Donovan only looked at changes in averages. Secondly, Loxley included all LLDCs with IMF Stand-bys under first as well as upper credit tranches, while Donovan included (excluded) some countries without Stand-by arrangements (some countries with Stand-by arrangements). Thirdly, in Loxley's methodology a programme period is defined as one that exceeds three months, while in Donovan's study if a programme exceeds twelve months it is taken as a two-year programme. Finally, Loxley compares programme LLDCs with all LLDCs, while Donovan compares his programme countries with NODCs.

<sup>17</sup> LLDC programme countries compared to all LLDCs performed better in terms of overall balance of payments, inflation and growth, but worse in terms of investment on both one and three year periods. Compared with NODCs, LLDC programme countries appear to have performed better in terms of overall balance of payments and inflation, but worse in terms of investment over both one and three year periods. Not much difference is exhibited in the performance of LLDCs and Donovan programme countries with respect to changes in savings, investment and consumption.

<sup>18</sup> Loxley states "A close look examination of his [Donovan's] programme countries shows, however, that many of them either did not draw at all on Fund facilities in their years in question (e.g., Honduras 1971, 1972, 1973; Morocco and Korea 1971; Panama 1971, 1978, 1979) or else drew only from the lower credit tranche (e.g., Zambia 1977; Tanzania 1975, 1976). At the same time, other upper credit tranche programme countries are inexplicably overlooked (e.g., Madagascar 1978, Guyana 1976, 1977; and Bangladesh 1979, 1980)" (pp. 4 - 5).

<sup>19</sup> World Bank (1989a) and Mosley and Weeks (1993 and 1994) have also used an approach similar to the with-without method to assess the effect of World Bank policies in sub-Saharan Africa. The World Bank divided countries into "strong adjusting", "weak adjusting" and "no reform programmes". This type of classification however, has been criticised for its failure to define clearly what is weak and strong and identify which countries are strong or weak adjusters. Mosley and Weeks (1993, p. 1586) note that the "simple rule of any such empirical test, no matter how sophisticated or simple, is that the criterion for the division of a sample into two parts must be prior to and independent of the outcome of the empirical calculations...(i.e., one must have an *ex ante* division of the sample." Based on the methodology described above, the World Bank argued the late 1980s are associated with a "recovery" in sub-Saharan Africa. Mosley and Weeks (1993) using the same performance measures namely real GDP, investment and export growth for the period 1980-90 compare countries with World Bank programmes and those without. Their results suggest that programmes had a neutral effect on the rate of growth, a positive effect on export growth and a negative effect on investment compared to non-programme countries. Mosley and Weeks (1993) also find that improvement in the performance measures is positively related to completion of programmes. Their results for the social indicators also suggest that programme countries have higher per capita food production and higher infant mortality relative to non-programme countries. This last point is supported by the decline in expenditure on social services. See Parfitt (1990) for a further critique of the approach adopted by the World Bank.

<sup>20</sup> The issue of sample-selectivity bias is closely associated with the Nobel Prize winner James Heckman who pioneered a method for removing the bias in modelling wage determination in the labour market (see Heckman and Sedlacek, 1985).

<sup>21</sup> The balance of payments, the current account and the fiscal deficit are measured as proportions of GDP. The rate of inflation, the rate of growth, the rate of growth of domestic credit and changes in the terms of trade are expressed as percentage changes. Other variables include a dummy variable; the real effective exchange rate lagged one period and a trend variable that reflects the benefits of growth on other markets.

<sup>22</sup> See Table 3 in Khan (1990) for a complete report of the results.

<sup>23</sup> Khan (1990) acknowledges that one-year comparisons are too short to capture complete programme effects or sustainability. Conversely too long period comparisons run the risk of including non-programme factors in the analysis. Therefore, Khan argues that the results for two and three year comparisons indicate that the positive effects on the current account, the balance of payments and inflation are increased, and the negative effects on growth decreased.

<sup>24</sup> The countries are divided into three groups: early-intensive adjustment lending countries; programme countries and non-programme countries. The period was also divided into three: 1970-80, 1981-84 and 1985-88. The counterfactual was compared with the actual outcomes in the 1985-88 periods.

<sup>25</sup> The argument is that since the decision to adopt programmes is under the expectation that there will be an improvement in the target variables, the treatment of programme-participation variable (i.e. dummy variable) as exogenous will provide a biased estimate of IMF programmes. However, Mosley (1992b) pointed out that the dummy approach itself does not tell the full story of programme implementation, that is values of 1 and 0 are extremes and indicate that programmes are either implemented fully or are not implemented at all. However, there are cases where programmes are partly implemented and abandoned (see Killick 1995a).

<sup>26</sup> Mosley (1992b, p. 38) commented that Corbo and Rojas "leave out three crucial elements in the investment story" - "compression of the government development budget", "expenditure switching" (from investment to consumption) and "private sector knock-on effects" (the crowding-in argument).

<sup>27</sup> According to Khan and Knight (1981) — "the excess demand for money, however, creates a balance of payments surplus that increases the money stock, so that gradually the price level turns around and there is a period of both rising prices and rising output that continues until current output has increased by 10 per cent and domestic prices have risen to their initial level" (p. 66).

<sup>28</sup> The hypothetical demand side policies are defined as a 10 per cent reduction in the growth rate of domestic credit, nominal government expenditure and devaluation of 10 per cent. The supply side policy is defined as an increase of 2-3 per cent in the investment/GDP ratio.

<sup>29</sup> Similarly, the World Bank (1994) and Mosley *et al.* (1995) employed a single regression model to assess the effect of IMF/World Bank adjustment programmes in sub-Saharan Africa to analyse the effect of changes in macroeconomic policy variables on changes in GDP per capita between 1981-86 and 1987-91.

<sup>30</sup> Doroodian (1993, p. 855-856) gives a theoretical justification for the mathematical signs and magnitudes of the estimated coefficients. For instance, real devaluations are said to have "expansionary effects"... "as suggested by the traditional model"; reduction in fiscal deficit is said to have a positive effect on growth and the current account and a negative effect on inflation; the interest rate is reported to have a positive effect on growth and the current account (via capital inflow, savings and investment) and a negative effect on inflation and domestic credit is said to have an inverse relationship with growth and the current account and a positive relationship with inflation. Doroodian (p. 857) argues that this last result is "consistent with Rational Expectation hypothesis: increases in the money supply would fuel domestic inflation and cause a deficit in the current account balance." ... This findings support the IMF position that external disequilibrium is the consequence of excessive domestic demand."

<sup>31</sup> The current account, government consumption and the deficit are measured as a share of GDP, while growth is measured by domestic investment ratio.

<sup>32</sup> The regression model is similar to that employed in Barro (1991).

<sup>33</sup> There is a vast volume of case study material, which examines stabilisation and adjustment programmes in almost all programme countries. One example the use of survey data to evaluate the effect of policy reforms, particularly on poverty. One such study, Demery and Squire (1996 and 1997), investigated how changes in macroeconomic policy are conducive to poverty reduction. The head count index is analysed in relation to specific monetary, fiscal and exchange rate policy changes. Demery and Squire (1996, pp. 45-46) argue that their analysis; "presents the most compelling evidence to date that improvements in the macroeconomic policy regime of the kind usually associated with World Bank and IMF-supported adjustment programmes are consistent with a decline in the incidence of poverty overall." However, the use of survey data in such a context proves difficult mainly as the data are initially constructed for a different purpose and by different methodologies (see Weeks 1997).

<sup>34</sup> The study looks at 26 countries in Central and Eastern Europe, the Baltic, and Russia over 1993-1997.

<sup>35</sup> Out of the 305 programmes 251 were Stand-bys, 33 were EFFs and 21 were SAFs. The study also looked at programme non-completion by period of implementation and income of countries. The highest non-completion was recorded in the period 1990/91 - 1992/93, i.e. 61 per cent; 1986/87 - 1989/90, 56 per cent; 1983/84 - 1985/86, 41 per cent; and 1979/80 - 1982/83, 44 per cent (see Table 3.3 in Killick, 1995a).

<sup>36</sup> Stiles (1990) found that bargaining and compromise characterise IMF decision-making and debtors with long years of relationship and large debt to the IMF tend to control their national policy making, while small countries are dominated by IMF's conditionality.

<sup>37</sup> The variable for the political proximity of a member country to the U.S. is proxied by the votes a country casts in the U.N. General Assembly along with the U.S.



## Chapter 5

### IMF Programmes in Ethiopia and Uganda

#### 5.1 Introduction

Does the IMF achieve its stated objectives? The studies reviewed in the previous chapter applied various impact assessment methodologies to cross-section data and came up with conflicting and inconclusive results. This chapter uses the before-after and with-without approaches to assess the impact of IMF SAF, ESAF and PGRF programmes in Ethiopia and Uganda. In total, Ethiopia and Uganda implemented two SAF, four ESAF and two PGRF programmes between 1987 and 2004. These programmes introduced a number of macroeconomic policy measures including restraining the flow of domestic credit to the public sector; exchange rate and trade liberalisation; privatisation of state-owned enterprises; and financial liberalisation.

In Uganda, IMF programmes under SAF were initiated after the National Resistance Movement (NRM) came to power in 1986. In May 1987, under the Economic Recovery Programme (ERP), the reforms were broadened and refined with a view to increasing long-term growth (see World Bank, 1995b; 1997).<sup>1</sup> Since then the IMF and the World Bank identify Uganda as a model of successful reformer (IMF, 1996; World Bank, 2000a). The government's handling of the economy is widely regarded as a success story that earned it the name of "show case" (Ddumba-Ssentamu, *et al.*, 1999). In its assessment of Uganda's economic reform in the 1990s, the IMF asserts: "Uganda's reform and stabilisation programme has been a major success...Exports became more diversified, with noncoffee exports representing about 30 per cent of the total" (IMF *Survey*, 1996, p. 3). Similarly the World Bank pronounces: "Uganda's economic performance over the last decade has been impressive. The Government's reform programme has had considerable success in establishing fiscal discipline, restructuring public expenditure, opening up the economy and anchoring its reliance on market forces" (World Bank, 2000a, p. i).<sup>2</sup> By the mid 1990s the Ugandan development strategy focused

mainly on poverty reduction (MFPED, 2001b; Dijkstra and Donge, 2001). The Poverty Eradication Action Plan (PEAP), which was initiated in 1997 and revised in 2001, sets out the broad agenda for pro-poor policies. The PEAP, according to the government of Uganda, is its Comprehensive Development Framework (CDF) as well as its Poverty Reduction Strategy Paper (PRSP), which is based on four key pillars: 1) fast and sustainable economic growth and *structural transformation*; 2) good governance and security; 3) increased ability of the poor to raise their income; and 4) increased quality of the life of the poor (MFPED, 2001b).

In Ethiopia, from 1974 to 1991 the *Dergue* regime resorted to central planning, which had been the dominant thrust of government strategy.<sup>3</sup> In May 1991, the Ethiopian People's Revolutionary Democratic Front (EPRDF) threw the regime out of office. Ten months into office the EPRDF introduced its economic strategy under the title "*Ethiopia's Economic Policy During the Transitional Period*." The document set out the broad agenda which included: 1) changing the role of the state from direct producer to facilitator; 2) promoting private sector investment; 3) mobilising external resources; 4) continuing state ownership land; and 5) changing macroeconomic policies to suit these objectives (see TGE, 1991; Abegaz, 1994b; Hansson, 2001). In 1992, Ethiopia signed a SAF agreement with the IMF and began implementation of stabilisation and adjustment programmes.<sup>4</sup> The subsequent reforms under the ESAF and PRGF focused on adjustment and poverty reduction (IMF, 1999a). In June 2002 these strategies have been complemented by the PRSP known in the country as the "Sustainable Development and Poverty Reduction Programme" (MOFED, 2002).

The impact assessment here avoids the use of cross-section data, which enjoys popularity among researchers surveyed in the previous chapter. Instead a case-by-case study of macroeconomic performance in the two countries will be employed. The statistical tests will be accompanied by analysis of the two economies to provide context to numerical results and statistical significance or otherwise. Statistical methods known as the Mann-Whitney U-test and One-Way ANOVA test are used to assess the impact of IMF programmes.

The empirical assessment in this chapter reaches two conclusions. First, the findings broadly correspond with the survey of the empirical evidence in the previous chapter. The results confirm that there is only partial evidence to suggest that Ethiopia and Uganda fared differently from their pre-reform economic predicaments or performed as or better than Botswana, Namibia, Seychelles, and Sudan, which never implemented IMF SAF, ESAF and PGRF programmes and used here as benchmarks for with-without comparisons. In statistical terms, the short-term assessment, which is three years before and three years after programmes, shows that the impact of IMF lending is positive and significant on real GDP growth rate and real GDP per capita growth rate. However, the ESAF and PGRF programmes, beyond the first SAF bear little difference on both real GDP growth and real per capita GDP growth. The longer period comparisons, up to fifteen years before and ten years after, show that a significant improvement in both real GDP and per capita GDP growth rates for Uganda but not for Ethiopia.

The results for inflation indicate reduction for the post-programme period but they are statistically insignificant. Subsequent IMF programmes made no difference in the case of Ethiopia but for Uganda the reduction in the rate of inflation was significant. For Uganda subsequent programmes made no difference on the rate of inflation and the result was insignificant. The long-term comparisons show insignificant differences between the periods with IMF programmes and those without.

The results for the current account were statistically insignificant for the first SAF programmes in the post-programme period. For both countries the subsequent ESAF and PGRF programmes actually resulted in deterioration and the results are significant. The long-term comparisons of changes in the current accounts show insignificant changes for both countries. The results for the accumulation of international reserves in Ethiopia, measured in months of import coverage, imply that there has been a significant improvement in the first SAF but deterioration in the second ESAF. For Uganda the changes in international reserves were insignificant for the entire post-programme period.

The with-without comparisons show that there is no significant difference in real GDP growth and per capita growth of Ethiopia and Uganda under IMF programmes compared to growth rates observed in Botswana. Additional with-without comparisons show that there are no significant differences in inflation for Ethiopia and Uganda under IMF programmes compared to the inflation rates observed in Botswana. With-without comparisons also show that there are significant differences in the current account deficits and international reserve holdings of Ethiopia and Uganda, which deteriorated under IMF programmes compared to Botswana. Comparing outcomes in target variables for Ethiopia and Uganda with the average outcome for Botswana, Namibia, Seychelles, and Sudan, shows that no statistically significant difference was found in real GDP and GDP per capital growth rates. The inflation rate for Ethiopia is positive and significant compared to the average for countries without IMF programmes, but not for Uganda. The current account deficit is low and statistically significant for Uganda compared to the average for countries without IMF programmes. No significant difference is observed in the current account balance for Ethiopia compared to the average for countries without IMF programmes. As regards to international reserves both Ethiopia and Uganda exhibit lower and statistically significant coverage for months of imports compared to the average for countries without IMF programmes.

Recidivism, discussed in the previous chapter, was evident in both countries but made little difference to target variables. The findings in this chapter are consistent with those in the literature that repetitive IMF lending has been the practice in countries with low growth, balance of payments crisis, high inflation, overvalued exchange rate, primary export dependence, and high debt burden (Edwards and Santaella, 1993; Conway, 1994; Knight and Santaella, 1997; Conway, 2000; Bird, 2001 Bird *et al.*, 2002; Joyce, 2002). Recidivism meant that programmes are implemented to reverse previous failures of similar types of programme, leading to a vicious circle of IMF lending.

Failure to comply with conditionality and programme interruptions are often cited as leading to poor performance in target variables, and survey of the literature in the previous chapter has also found that compliance with IMF conditionality has been

problematic and a significant proportion of programmes have not been completed (Killick, 1995a; Mussa and Savastano, 1999; Bird, 2001). Here we also find that the first SAF in Uganda was not completed where 29 per cent of the approved loan was not drawn, and the subsequent ESAF and PGRF programmes were extended by 34 months from their expiry date. In the case of Ethiopia 67 per cent of the ESAF and 31 per cent of the PGRF loans were not drawn and the programmes were extended by 12 months.

When each of the SAF and ESAF/PGRF is compared to the preceding 9-10 years without IMF programmes, the results show that in the case of Uganda both the SAF and ESAF/PGRF make positive and significant differences in real GDP growth and per capita GDP growth rates compared to the years without IMF programmes. The results for the SAF are positive even though the programme was incomplete. For Ethiopia the findings are to the contrary. The period with the SAF and ESAF/PGRF, compared separately, made no statistically significant difference from the years without IMF programmes, even though the SAF was completed with no interruption or extension. The results for inflation show that only the second IMF programme or the ESAF made a difference in Uganda, where the programme was completed but with extension. None of the SAF programmes or ESAF/PGRF programmes made significant differences in the current account deficit compared to the period without IMF programmes. The ESAF in Uganda and all programmes in Ethiopia led to significant improvements in accumulation of international reserves despite incomplete and extended programmes. The findings here correspond with those in the literature that high rate of non-adoption is the norm and completion may or may not impact upon outcomes in target variables (Killick, 1984a, 1995a; Mercer-Blackman and Unigovskaya, 2000). The IMF often grants waivers and introduces modifications to programmes, which must be taken into account in impact analysis to qualify overestimation or underestimation of programme effects.

The findings in this chapter also show that over half of fiscal and monetary targets for policy instruments were not complied with. The before-after comparisons reveal that for both Ethiopia and Uganda no significant change was found in the flow of domestic credit to the governments before and after IMF programmes. In Uganda domestic credit

as a share of total domestic credit began to fall only after six years of IMF programme. In fact a significant deterioration in the overall fiscal deficit as a share of GDP was found under the SAF and ESAF programmes in Uganda. The tests for Ethiopia are insignificant but show that the fiscal deficit has remained constant for both the ten years with and without IMF programmes. The real effective exchange rate significantly depreciated under both the SAF and ESAF programmes in Ethiopia compared to the period without IMF programmes. In contrast, the first SAF in Uganda did not impact on the exchange rate but only a significant depreciation was achieved under the second ESAF programme. The long-term before-after comparisons also show depreciation in the exchange rate for both Ethiopia and Uganda. The change in real interest rates after IMF programmes was insignificant in Ethiopia but positive and significant in Uganda.

The second conclusion is that an impact assessment is only instructive if, rather than measurement of short-term financial relief, it deals with the fundamental causes of underdevelopment and how these have been resolved. This leads us to question: what do improvements in *some* macroeconomic variables at *some point in time* but not throughout the programme period mean in transforming the two economies in question? The finding is that behind ostensibly fascinating statistics on growth rates we uncover economies with little structural transformation. High growth, low inflation and external financial transfers are not ends in the development process. This chapter will illustrate that despite numerous programmes, both countries have shown little structural transformation, measured as changes in the share of manufacturing in gross national product, putting in question the sensibility of the IMF objectives. The test results show that a statistically significant decline of 1 per cent in the share of manufacturing for Ethiopia under IMF programmes comparing the years without IMF involvement. The results for Uganda indicate no significant difference in the structure of the economy between the years with IMF programmes and those without since 1965. A statistically significant 1-percentage point improvement was observed, but only when the period of high industrialisation (1965-1971) is discounted.

The contribution of this chapter is in assessing impact of IMF programmes to country cases as well as in moving away from a presumption of negative and positive effects of IMF programmes to identifying whether the objectives set by the IMF are sensible or not. The results show that real GDP and GDP per capita growth rates as well as reserve holdings have improved, but there is little evidence to suggest that IMF programmes meet all their objectives or they brought about significant changes in the economic development of Ethiopia and Uganda. Both countries adopted IMF programmes with the advent of new regimes and at a time when protracted civil wars ended. The changes in the macroeconomic target variables - good or bad - may or may not be due to IMF programmes but due to other factors that coincided not least with change of government and policies that would have been adopted in some form in any case.

The chapter is organised as follows. Section 5.2 sets out the before-after and with-without approaches and identifies key methodological as well as data-related issues. Section 5.3 discusses the results obtained by applying statistical tests for the target and instrument variables included in IMF programmes. Section 5.4 argues the objectives set out by the IMF are far from sensible as they fail to translate economic reform into structural transformation. Concluding remarks are provided in Section 5.5.

## 5.2 Methodological and Data-Related Issues

A simultaneous model for evaluation of IMF stabilisation and adjustment programmes is set out below similar to that found in the literature.<sup>5</sup>

$$\Delta y_{ij} = \beta_{0j} + \Delta x_i' \beta_{ij} + \Delta W' \alpha_{ij} + \beta_{ij}^{IMF} \Delta d_i + \varepsilon_{ij} \quad (5.1)$$

$$\Delta x_i = \gamma[y_i^d - (y_i)_{-1}] + \eta_i \quad (5.2)$$

Where  $y_{ij}$  denotes the  $j$ th outcome for target variable observed in a country  $i$  (e.g. the current account balance, rate of inflation and the rate of growth);  $x_i$  is  $\phi$ -element

vector of policy variables that would be observed in country  $i$  in the absence of IMF programmes (e.g. level of domestic credit, real exchange rate, and fiscal deficit);  $W$  is  $\phi$ -element random vector of world non-programme variables (e.g. the terms of trade). Equation 5.1 shows the change in the macroeconomic target variable is a function of the change in the policy instruments that would have occurred in the absence of IMF programmes ( $\Delta x_i$ ), the change in the exogenous non-programme variables ( $W$ ), the effect of IMF programmes ( $\beta_{ij}^{IMF}$ ) and other random shocks ( $\varepsilon_{ij}$ ). The dummy variable  $d_i$  assumes a value of 1 if a country has IMF programmes and a value of 0 otherwise. The parameter  $\beta_{ij}^{IMF}$  is therefore what measures the impact of IMF programmes during the programme period on the target variables denoted by  $y_{ij}$ .

Equation 5.2 assumes that policy makers react to perceived disequilibria in macroeconomic target variables. Therefore, the change in country  $i$ 's policy instruments before and after IMF programmes will be a function of the difference between the desired value of the target variables in the post-programme period,  $y_i^d$ , and their actual value in the pre-programme period,  $y_{ti-n}$ . The coefficient  $\gamma$  indicates the responsiveness of the policy instruments to target disequilibria. The parameter  $\beta_{ij}^{IMF}$  thus implies that the policy instruments denoted by  $x_i$  measure the policies adopted in the absence of IMF programmes. The value for vector  $x_i$  is observed from data for pre-programme period and for countries without IMF programmes, which are counterfactual values. For programme periods or for countries with programmes, the value for vector  $x_i$  is estimated by equation 5.2 or the policy reaction function and shows the determinants of macroeconomic policy changes initiated by the authorities in the absence of programmes. By modelling the behaviour of policy makers, the above equations assess the effect of stabilisation and adjustment programmes by estimating the counterfactual implied by the pre-programme period and non-programme countries. The assumptions here are that  $\beta_{0j}$ ,  $\beta_{ij}$  and  $\alpha_{ij}$  are uniform before and after IMF programmes and across countries.



Using the above model the before-after estimator captures the effect of IMF programmes as specified in equation 5.3, which assumes all the coefficients in equation 5.1 are zero except  $\beta_{ij}^{IMF}$ .

$$\Delta y_{ij} = \hat{\beta}_{ij}^{IMF,BA} \quad i \in P \quad (5.3)$$

where superscript BA denotes before-after and  $P$  is the set of programme countries, the before-after estimator compares the mean outcome of the macroeconomic target variables between the pre-programme and the programme periods to calculate the effect of IMF involvement.

The with-without or control-group approach compares countries with programmes and those without. The basic idea is to estimate the counterfactual in programme countries by the macroeconomic outcomes observed in non-programme countries. Where  $(\overline{\Delta y_i})_P$  and  $(\overline{\Delta y_i})_N$  are mean changes in the target variable for programme and non-programme countries and superscript WW denotes with-without,  $\beta_j^{IMF}$  is estimated by;

$$\hat{\beta}_j^{IMF,WW} = (\overline{\Delta y_i})_P - (\overline{\Delta y_i})_N \quad (5.4)$$

The difference in the mean changes in the target variables is obtained by running statistical tests for both programme and non-programme countries. Where  $A$  denotes a set of programme and non-programme countries,  $\beta_0$  is a constant and  $d_i$  is a dummy variable, the following equation is tested to obtain the mean values for both groups.

$$\Delta y_j = \beta_0 + \beta_j^{IMF,WW} d_i \quad i \in A \quad (5.5)$$

The value for the estimated coefficient  $\beta_j^{IMF,WW}$ , shown in Equation 5.5, measures the difference between the mean changes of the target variables for programme and non-programme countries  $((\overline{\Delta y_i})_P - (\overline{\Delta y_i})_N)$ .

The above models are applied to the countries under study and the significance of the programme estimators  $\hat{\beta}_{ij}^{IMF,BA}$  and  $\beta_j^{IMF,WW}$  are statistically tested using the Mann-Whitney U-test and the One-Way ANOVA test. The Mann-Whitney U-test, extensively applied in the literature to assess impact of IMF programmes, compares two groups of observations, especially when measurements are not normally distributed. The One-Way ANOVA method tests for differences between the means of independent samples by using analysis of variance, which partitions the total variance into comparable components, in our case between years and countries with IMF programme and those without. Standard t-tests are used where the data pass normality tests.

Statistically significant  $\hat{\beta}_{ij}^{IMF,BA}$  and  $\beta_j^{IMF,WW}$  imply that the mean changes in the target variables between pre-programme period or programme countries are significantly different from the changes in post-programme periods or non-programme countries. Since we are looking for any difference in target variables, an increase, or a decrease, our test is a two-tailed hypothesis test. The chosen level of confidence is 0.05 where two-tail probability value is the actual probability of the differences occurring by chance, be it under the before-after or with-without comparisons. The two-tail results confirm that the  $H_0$  must be rejected and the  $H_A$  accepted in both tests. Here we formally test whether the IMF programme significantly changed target variables, for instance real GDP per capita growth rates in Uganda and Ethiopia before and after programmes or compared to countries that did not adopt IMF programmes. The null-hypothesis and alternative-hypothesis are tested as follows:

#### **Before-After Tests:**

$H_0$  = the IMF programme had no effect - there is no difference between target or policy variables for Ethiopia and Uganda before and after IMF programmes.

$H_A$  = the IMF programme had a significant effect - there is a difference between target or policy variables for Ethiopia and Uganda before and after IMF programme.

**With-Without Tests:**

$H_0$  = the IMF programme had no effect - there is no difference between target variables for Ethiopia or Uganda and for Botswana or for countries without IMF programme.

$H_A$  = the IMF programme had a significant effect - there is a difference between target variables for Ethiopia or Uganda and for Botswana or for countries without IMF programme.

The data for the target and policy variables are obtained from the International Financial Statistics (IFS) and World Bank Africa Databases. Real GDP per capita growth and real growth of GDP are given as annual percentage growth rates. Inflation is measured by the consumer price index, which reflects annual percentage changes in the cost to the average consumer of acquiring a fixed basket of goods and services. The current account is measured as share of national income. International reserves are in months of imports of goods and services. Flow change in domestic credit to government includes changes in net claims on central government, and changes in claims on state and local government as well as on non-financial public corporations. The data are annual flows in local currencies. The overall deficit excludes all grants and it is calculated as a share of GDP. The real effective exchange rate is based on a nominal rate adjusted for relative changes in consumer prices. Real interest rates are nominal deposit rates deflated by the consumer price index.

### 5.3 Statistical Tests and Results

Table 5.7 shows that between 1987 and 2004, the period covered under this study, Ethiopia and Uganda implemented two SAF, four ESAF and two PGRF programmes in total. The statistical tests begin with the conventional approach representing an IMF programme as a dummy variable signifying whether a programme was ongoing or not. As noted above, the effect of IMF programmes on real GDP per capita growth, real growth of GDP, the inflation rate, the current account and international reserves is

estimated using the before-after and with-without approaches. The IMF programme is captured through expected changes in the three policy variables: the flow of domestic credit to the government, the overall fiscal deficit and the real exchange rate.

A complete set of statistical results are reported in the tables under Appendix 5.1. This section will refer to the results but, to conserve space, only the relevant coefficients and parameters are reported. Four types of tests are conducted. The first test relates to the period three years before and three years after all IMF programmes. Second, the tests examine the long-term effect of IMF programmes, typically up to ten years before and ten years after programmes. Third, tests apply the with-without approach to a single country or one-to-one comparison as well as to one-to-many comparisons. The one-to-one comparison takes Botswana as the counterfactual or benchmark and compares its values for macroeconomic variables with each of the countries under study: Ethiopia and Uganda. The one-to-many comparison compares the average macroeconomic outcome for Botswana, Namibia, Seychelles, and Sudan (countries without IMF programmes) with Ethiopia and Uganda. The final test focuses on assessing the impact of IMF programmes by type, that is, the individual effects of the SAF and the ESAF are evaluated. The test results are presented below.

### **5.3.1 Test Results for Real Per Capita GDP Growth and Real Growth of GDP**

Tables 5.8 and 5.9 show the short-term, three years before and three years after, effects of IMF programmes. In statistical terms, the first three years of IMF's presence is associated with positive and statistically significant effects on both real per capita GDP growth and real growth of GDP for both Ethiopia and Uganda. These positive outcomes were achieved under the first (or SAF) programmes in both countries. Subsequent short-term comparisons show that the ESAF and PGRF programmes, beyond the SAF, did not significantly change real GDP growth and real per capita GDP growth. The results indicate that no statistically significant difference is observed between the growth rates achieved under the first SAF and successive ESAF and PGRF programmes.

Table 5.10 and 5.11 show that under long-term comparisons, up to fifteen years before and ten years after IMF programmes, the improvements in both real GDP per capita growth and GDP growth rates for Uganda were statistically significant. The results for Ethiopia are insignificant, even though there have been increases in real GDP per capita growth and GDP growth rates in the years with IMF programmes compared to the years without IMF programmes. However, per capita income remains low in both Ethiopia and Uganda at US\$298 and US\$120, respectively.<sup>6</sup>

Comparing individual programmes, SAF and ESAF, with the years without IMF programmes reveals that both programmes made positive and significant contribution to real GDP per capita growth and GDP growth rates for Uganda. As Table 5.12 and 5.13 show none of the SAF and ESAF programmes made a significant contribution to Ethiopia's real growth rate of GDP per capita and real GDP growth. These results are consistent with those obtained by short-term comparisons for Ethiopia, that only the first SAF programme was associated with positive and significant growth rates.

The one-to-one with-without comparisons show that neither Ethiopia nor Uganda exhibited statistically different growth rates in real GDP per capita growth and real GDP growth compared to Botswana (see Table 5.14). The one-to-many comparisons also show that no statistically significant difference was found between the growth rates of Ethiopia and Uganda compared to the four countries' average or countries without IMF SAF and ESAF programmes (see Table 5.15).

Largely the effect of IMF programmes on real GDP per capita and real GDP growth rates is only significant in the initial three years under SAF compared to the previous three years for Ethiopia. Overall Uganda performed better than Ethiopia under IMF programmes, particularly on longer-term comparisons. However, both countries performed no better than countries that did not adopt IMF programmes.

In the previous chapter we dealt with the question "who adopts IMF programmes and why?" Among others, the economic school argues that IMF programmes are supplied

and demanded because the recipient country faces low growth rates, balance of payments crisis, high inflation, overvalued exchange rate, and high debt burden (Edwards and Santaella, 1993; Conway, 1994; Knight and Santaella, 1997; Mussa and Savastano, 1999). It is the case that both Ethiopia and Uganda adopted IMF programmes at the time their economies were in crisis. It is no surprise that the first three years of IMF financial injection as well as the end of conflicts and wars brought about improvements in growth rates that might have been expected in any case. It is difficult to ascertain whether growth and low inflation are policy induced or simply resulted from restoration of peace and stability.

### 5.3.2 Test Results for the Rate of Inflation

As depicted in Table 5.8 and 5.9, the results for short-term tests show that both countries reduced their inflation rates under IMF programmes, but the results are statistically insignificant. Subsequent IMF programmes made no difference in the case of Ethiopia but for Uganda the reduction in the rate of inflation became significant in the second ESAF programme. The third programme or the ESAF made no difference on the rate of inflation and the result was insignificant. The results for Uganda become significant as the inflation rate was reduced from 153 per cent for the pre-ESAF period (1987-1989) to 19 per cent for the ESAF and post-ESAF period (1990-1997).

The long-term comparisons in Tables 5.10 and 5.11 show insignificant differences in inflation rates between the years with IMF programmes and those without for both Ethiopia and Uganda. The test results for individual programmes show that none of the SAF and ESAF programmes significantly contributed to reductions in the inflation rate for Ethiopia. For Uganda the results are consistent with the short-term test findings that the second programme or the ESAF significantly reduced the inflation rate and the reduction was statistically significant (see Tables 5.12 and 5.13).

The with-without comparisons in Tables 5.14 and 5.15 show that there is no significant difference in the inflation rates for Ethiopia and Uganda under IMF

programmes compared to the inflation rates observed in Botswana. Comparison of inflation rates for Uganda with the average outcome for the four countries without IMF programmes (Botswana, Namibia, Seychelles, Sudan) shows that no statistically significant difference was found. The results for Ethiopia are significant.

Overall two conclusions can be made on the impact of IMF programmes on the inflation rate. First, for Uganda the reduction in the rate of inflation is significant and this has been achieved in the second ESAF programme after six years of IMF engagement. Second, the inflation rate for Ethiopia shows a significant difference compared to the average for countries without IMF programmes, mainly because Ethiopia always had historically low inflation rates. Ethiopia's inflation rate averaged 6.2 per cent between 1966 and 2001 compared to 15.7 for the four countries without IMF programmes.<sup>7</sup> The low inflation rates in Ethiopia can hardly be attributed to IMF programmes. In fact, the Ethiopian economy exhibited deflationary tendencies throughout the 1990s (Hailu, 1997).

As shown in Table 5.1, there were deflations in prices of food, household items, clothing, transportation and medical care between 1993 and 1997. In the year 1997, prices of food and household items fell by as much as 7.1 per cent and by 10.4 per cent, respectively. Prices of clothing fell by 8.1 per cent and 0.8 per cent in 1994 and 1995, while prices of transportation fell by 3.8 per cent in 1997.

**Table 5.1 - Trends in Inflation Rates, 1990/91 – 1996/97**

Years	Food	Household Items	Clothing	Transportation	Medical Care	General CPI
1991	23.3	23.0	10.4	3.1	0.9	12.1
1992	24.9	15.3	14.0	-0.9	5.9	11.8
1993	8.1	-2.2	55.4	24.9	60.9	29.4
1994	1.2	1.6	-8.1	17.8	35.0	9.5
1995	18.3	0.0	-0.8	2.1	33.0	10.5
1996	-0.3	6.6	2.6	3.5	-17.3	-1.0
1997	-7.1	-10.4	7.6	-3.8	-15.5	-5.8
1998-2002	--	--	--	--	--	-0.5

*Source: MEDaC (1999) and NBE (2003)*

The largest fall in prices was in medical care where deflations of -17.3 per cent and -15.5 per cent were recorded in the years 1996 and 1997, respectively. Deflations of -1.0 per cent and -5.8 per cent were registered for the General CPI in the years 1996 and 1997, respectively. Deflation remained the feature of prices developments where the average General CPI for 1998-2002 was -0.5 per cent. Azeze's (1996) non-parametric assessments show that total domestic credit flow on the three years average fell from 15.2 per cent before the programme to 13.6 per cent. This raises the question why deflationary policies are advocated in Ethiopia.

### 5.3.3 Test Results for Current Account Balance and International Reserves

As Tables 5.8 and 5.9 illustrate, the results under the short-term tests for the current account balance were insignificant for the first SAF programmes for both countries. Successive ESAF and PGRF programmes essentially resulted in deterioration of the current account and the results are significant. The results for the accumulation of international reserves in Ethiopia, measured in months of import coverage, imply that there have been statistically significant improvements in the first SAF but deterioration in the second ESAF. For Uganda the changes in international reserves were insignificant for the entire programme period.

Comparing ten years under IMF programmes with those eight years without programmes (or the *before* period in the before-after), show that the current account deficit for Ethiopia improved from 1.9 per cent to 1.8 per cent of GDP. For Uganda the improvement was from 9.2 per cent to 7.3 per cent of GDP comparing the fifteen years with IMF programmes with the seven years without IMF programmes. However, as shown in Table 5.10 and 5.11 these changes in the current account balances were statistically insignificant for both countries.

For the same period the long-term tests show that there have been statistically significant and positive changes in the reserve holdings of both countries. International reserve holdings for Ethiopia improved from 1.6 months before to 4.4 months import



coverage after IMF programmes. For Uganda the improvement was from 1.2 months to 3.4 months. Tests on individual programmes indicate that both the SAF and ESAF contributed to improvements in reserve holdings for Ethiopia. Only the ESAF programme contributed to reserve holdings in Uganda (see Tables 5.12 and 5.13).

One-to-one with-without comparisons, as shown in Tables 5.14 and 5.15, confirm that there are significant differences in the current account deficits of Ethiopia and Uganda, which deteriorated under IMF programmes from -4.5 to -6.3 per cent of GDP compared to the current account balance for Botswana, which increased its surplus from 5.3 per cent to 8.5 per cent of GDP. Botswana also increased its reserve holdings from 12.3 to 23.4 months of import coverage compared to an increase from 1 to 3.7 months of imports for Ethiopia and Uganda under the ten years before and ten years after programme calculations. No significant difference is observed in the current account balance for Ethiopia compared to the four countries without IMF programmes. For Uganda lower and statistically significant difference in the current account deficit is found compared to the average for countries without IMF programmes. The deficit for the four countries averaged 4 per cent of GDP compared to 7 per cent for Uganda. International reserve holdings for both Ethiopia and Uganda are significant and lower compared to the average for countries without IMF programmes. Reserves could cover 7 months of imports for the countries without IMF programmes compared to 4 months for Ethiopia and 5 months for Uganda.

Despite successive ESAF and PGRF programmes the results overall indicate that Ethiopia and Uganda did not significantly improve the deterioration in their current account deficits. Both the short-term and long-term tests imply that no statistically significant difference was observed before and after IMF programmes. IMF programmes had positive and significant impact on the reserve holdings of both countries, but these improvements are not unique. Botswana and the countries without IMF programmes fared much better both in having lower current account deficits and larger import coverage out of their reserve holdings.

The above results are not surprising given the growth of imports following trade liberalisation. The new government in Ethiopia acknowledged that its first step was to replace “existing quantitative restrictions with tariffs and encouraging investment in export-oriented undertakings” (TGE, 1991, pp. 32-33). And when the SAF agreement with the IMF was concluded in 1992, the tariff regime has been overhauled, which began with reducing the negative imports list from 102 to 43 items on 1 March 1994 (Hansson, 1995; Abraha, 1996). As Table 5.2 presents, the maximum tariff rate was reduced from 209 to 30 per cent and the numbers of tax exemptions were reduced from 327 to 138 per cent, while the trade weighted average rate was reduced from 21.5 per cent to 14.9 per cent and the number of tariff bands declined from 15 in 1993 to 7 in 2000. The average unweighted and the item-weighted tariff rates were reduced from 31 per cent and 29 per cent in 1994 to 17.1 per cent and 19.5 per cent in 2000, respectively.

The test results for the current account balance are consistent with the argument that the demand for imports, particularly for intermediate goods, is highly inelastic for import-dependent economies such as Ethiopia and Uganda.<sup>8</sup> In Uganda, the increase in imports is linked to increased programme aid, particularly import-support. The composition of imports is about 54 per cent investment goods such as machinery and transport equipment and 26 per cent intermediate goods including fuels and chemicals (Ddumba-Ssentamu, *et al.*, 1999). Ddumba-Ssentamu, *et al.* (1999) note: “it is not easy to conclude on whether aid *financed* the trade or current account deficit, or *created* it. In the absence of aid, imports would have been at lower levels and economic growth would also have been lower” (p. 40).<sup>9</sup>

**Table 5.2 – Structure of Import Duties, 1993-2000 (number and per cent)**

	1993	1994	1995	1996	1997	1998	1999	2000
Number of Tariff Bands	15	10	10	9	8	8	7	7
Maximum Tariff Rate	209	80	80	60	50	50	40	30
Average Unweighted Tariff Rate	--	31.0	31.0	25.6	21.3	21.3	17.1	17.1
Item-Weighted Tariff Rate	--	29.0	--	--	--	21.5	19.5	19.5
Trade-Weighted Average Tariff Rate	--	21.5	--	--	--	15.9	14.9	14.9

*Source: IMF (1999a and 2002a)*

In Ethiopia, trade liberalisation has led to an increase in import intensity of the industrial sector, which is in conflict with the expenditure-switching objectives of the adjustment package as discussed in Chapter 3. Imports make up the inputs as follows: 96 per cent for food and beverage; 78 per cent for machinery and engineering workshops; 37 per cent for textiles; 30 per cent for leather processing; 69 per cent for chemicals and 98 per cent for medicine and medical equipment (Wole, 1996). In 1992, import intensity, measured by the ratio of the value of imported input to total value of domestic inputs, has been 0.33, which increased to 0.44 in 1997 (MEDaC, 1999). As Table 5.3 illustrates capital goods make up a higher proportion of imports at 31.8 per cent followed by consumer goods 27.6 per cent, fuel 17.1 per cent, and semi-finished goods 9.5. Transport and industrial goods take a large proportion of capital goods, while non-durable goods such as food (14.2 per cent) hold the lion's share of consumer goods.<sup>10</sup> Raw materials and medical goods make up less than 3 per cent in total value of imports.

**Table 5.3 – Ethiopia: Percentage Share in Total Value of Imports, 1992-1998**

	1992	1993	1994	1995	1996	1997	1998	Average
Raw Materials	1.6	2.0	1.6	2.0	2.1	2.2	2.2	2.0
Semi Finished G.	6.8	4.8	6.2	9.2	12.5	13.9	13.3	9.5
• Chemicals	0.9	3.4	3.6	3.4	3.6	4.2	3.9	3.3
• Fertilizers	4.9	0.4	1.3	4.2	7.2	7.8	7.6	4.8
• Textile	1.0	1.0	1.3	1.6	1.7	1.9	1.8	1.5
Fuel	13.8	18.8	24.3	15.9	15.2	16.5	15.5	17.1
Capital Goods	25.8	36.3	26.1	31.4	32.6	36.7	33.5	31.8
• Transport	18.6	23.9	12.0	13.2	13.6	16.7	13.9	16.0
• Agricultural	0.1	0.3	0.6	1.9	2.0	2.3	2.4	1.4
• Industrial	7.1	12.1	13.5	16.3	17.0	17.7	17.2	14.4
Consumer Goods	28.4	29.3	28.8	30.8	27.9	21.1	26.9	27.6
• Durables	7.6	7.8	8.7	8.6	8.0	8.5	7.9	8.2
• Non Durables	20.8	21.5	20.1	22.2	19.9	12.6	19.0	19.4
Food	15.0	15.9	13.8	17.0	15.2	7.8	14.4	14.2
Medical Goods	1.9	3.6	4.1	3.3	2.9	3.0	2.8	3.1

*Source: Calculated from MEDaC (1999)*

#### 5.3.4 Test Results for Policy Variables

The short-term comparisons in Table 5.8 and 5.9 show that for both Ethiopia and Uganda, no significant difference was observed in the flow of domestic credit to

government before and after IMF programmes. No significant change was registered in the fiscal deficit for Ethiopia compared to the pre-programme period. According to Azeze (1996) M2 slightly rose from 16.4 per cent to 16.9 per cent. The results for the changes from 1994 to 1995 are of particular interest: M2 rose from 10.3 per cent to 23.5 per cent; M1 rose from 8.6 per cent to 21.3 per cent; and total domestic credit increased from 7.3 per cent to 14.5 per cent. In Uganda domestic credit as a share of total domestic credit began to fall only after six years of IMF programme.

A statistically significant increase in the fiscal deficit was observed in Uganda.<sup>11</sup> The test here shows that real effective exchange rate significantly depreciated under the SAF programmes in Ethiopia compared to the three years period without IMF programmes. The real effective exchange rate significantly depreciated under the SAF programmes in Ethiopia compared to the three years period without IMF programmes. In contrast, the first SAF in Uganda did not impact on the exchange rate but only a significant depreciation was achieved under the second ESAF programme. Interest rates in both countries were liberalised in 1994 and comparing the three years before programmes with those after reveals that the change in real interest rates was insignificant in Ethiopia but positive and significant in Uganda.

Table 5.10 and 5.11 show that under the long-term tests, no significant changes were found in the flow of domestic credit to the governments for both Ethiopia and Uganda. The same result is found for the fiscal deficit. A significant deterioration in the overall fiscal deficit as a share of GDP was found under the SAF and ESAF programmes for Uganda from 3.8 per cent to 7.9 per cent. The tests for Ethiopia are insignificant but show that the fiscal deficit has remained the same at 9.5 per cent of GDP for both the ten years with and without IMF programmes. It was not possible to control the fiscal deficit as the government also adopted the World Bank supported Sectoral Investment Programmes (SIPs) and Sector Development Programmes (SDPs), which committed the government for up to ten years spending. Notable sectors are roads, energy, education, and health (Abegaz, 1999). The fiscal balance in the first years of adjustment remained high because rehabilitation and reconstruction necessitated increased spending. Later, the

conflict with Eritrea in 1998 increased government spending, which implied that the liberalisation process and macroeconomic stability were not free from political developments (Addison and Ndikumana, 2003). The long-term before-after comparisons - ten years with IMF programmes versus seven years without programmes for Ethiopia and fifteen years with and seven years without for Uganda - show significant depreciations in the exchange rates for both countries.

Tests based on individual programmes depict no significant difference was found between the flow of domestic credit to the governments under the SAF and ESAF programmes compared to the period without IMF programme. This applies to both Ethiopia and Uganda. For Ethiopia none of the programmes brought about significant changes in the fiscal deficit, while for Uganda the deficit deteriorated under the ESAF programmes. Both the SAF and ESAF led to real exchange rate depreciations for Ethiopia. For Uganda the first programme did not impact upon the exchange rate, but successive ESAF programmes were associated with depreciation (see Tables 5.12 and 5.13).

Overall the tests for the policy variables lead to the conclusion that: 1) no significant difference was observed in the flow of domestic credit to government throughout the programme period; 2) no significant change was registered for Ethiopia and a deterioration was found in the fiscal deficit for Uganda; 3) IMF programmes were associated with significant real exchange rate depreciations for both Ethiopia and Uganda; and 4) liberalisation of the financial sector in Uganda led to significant real positive interest rates, but not for Ethiopia. Therefore, IMF programmes were not *fully* implemented in Ethiopia and Uganda.

### 5.3.5 Discussion on Policy Variables

**Monetary Policy:** The Ethiopian government announced that “the state should take urgent measures for achieving fiscal balance” and “monetary policy should be such as to ward off inflationary trends resulting from the circulation of money in volumes beyond

the economy's capacity" (TGE, 1991, pp. 36-37).<sup>12</sup> However, reductions in the level of domestic credit to the government fell short of achieving set targets under the IMF programme. This was mainly due to the "downward fiscal-inflexibility", which arises from the need for rehabilitation and reconstruction of a war-torn infrastructure (Addison and Ndikumana, 2003). According to Azeze (1996), in the first year of credit squeeze (1993), the deviation from the target was 75 per cent and in 1994 the deviation was 94 per cent. In the third year of stabilisation (1995-1996) the flow of domestic credit to government deviated by minus 145 per cent. For the growth of total domestic credit and broad money, the evidence shows that targets have been met only for 1993 and 1994. While in 1995 the deviation from target on the growth of total domestic credit was 45 per cent and 86.5 per cent for broad money.

In Uganda domestic credit as a share of total domestic credit began to fall only after the monthly cash flow mechanism was introduced in 1992, which meant that government expenditures could not exceed the sum of revenues plus foreign grants and loans (Henstridge and Kasekende, 2001). A cash flow system involves monthly monitoring of cash disbursements to line ministries, which allows flexibility to adjust in response to revenue and donor finance changes. Most importantly the system restrained deficit financing (Stasavage and Moyo, 2000). The system was introduced in response to repeated shortfalls in the financing requirement of various ministries and government institutions and seems to have had two effects: a reduction of the deficit before grants, and a reduction of the deficit after grants to such an amount that it can be fully financed by external loans (Dijkstra and van Donge, 2001).

**Exchange Rate Policy:** In 1974, the *Dergue* regime had decided to keep the value of the birr but brought to halt transactions in foreign exchange outside of the National Bank of Ethiopia (NBE). The foreign exchange restriction imposed on the private sector in the face of a fixed exchange rate regime caused a parallel market to emerge and illegal trade flourished (Kidane, 1994; Kibret, 1994). In the aftermath of the *Dergue*, devaluation and price liberalisation became the central blocks of the stabilisation and adjustment package (Hansson, 2001). The new government's November 1991 official line stated that:

The exchange of the birr compared to the US dollar is unrealistically overvalued. This clearly has its own negative impact on the country's foreign trade. While there is, in principle, a basic understanding that corrective measures should be taken, it should also be understood that an adjustment of the exchange rate would have to be backed by a dependable supply base. In the short run, the impact of exchange rate adjustment on the country's foreign trade would be minimal. On the other hand, any major change in the exchange rate of the birr without economic recovery and growth is likely to exacerbate problems of inflation, unemployment and economic decline, thereby seriously endangering the process of consolidating peace, stability and democracy. Therefore, exchange rate adjustment should be a gradual process to be undertaken in tandem with improvements in the performance of the economy on the basis of appropriate studies. There could also be other alternatives, which may have to be explored (TGE, 1991, pp. 35-36).

A few months after stating the above the government, under the SAF arrangement, devalued the official value of birr by 142 per cent on 30 September 1992 (from birr 2.07 to 5.01 per US\$). On May 1993 the exchange rate was allowed further to adjust on a bi-weekly auction market, which started with allocation of foreign exchange for imports of goods worth more than US\$5,000 (Warner, 1996).<sup>13</sup> However, it has also been found that even though the government pegs the official rate to the parallel market rate, dissatisfied demand caused a persistent parallel market premium. This is due to the fact that unsuccessful bidders at the auction market increased the demand for the parallel market rate (Patterson, 2001).<sup>14</sup>

**Table 5.4 - Sectoral Percentage Share of Total Export Earning, 1990-1998**

Years	Private Sector	Government
1990	16.2	83.8
1991	15.6	84.4
1992	18.9	81.1
1993	28.8	71.2
1994	41.9	58.1
1995	48.2	51.8
1996	53.9	46.1
1997	63.0	37.0
1998 (first five months)	78.5	21.5

*Source: Calculated from MEDaC (1999)*

Despite a large devaluation demand for import of intermediate and capital goods proved to be highly inelastic (Kibret, 1994).<sup>15</sup> From the liberalisers point of view perhaps

the good news is that the share of the private sector in the export sector has been significantly rising. As shown in Table 5.4 the share of the private sector grew from 16.2 per cent in 1990 to 78.5 per cent in 1998, while the share of government export earnings fell from 83.8 per cent to 21.5 per cent in the same period.<sup>16</sup>

Information on exchange rate policy in Uganda is relatively widely available as open public debate took place on the merits and de-merits of devaluation (see Mamdani, 1990, 1991; Tumusiime-Mutebile, 1991). In 1990 retention of all foreign exchange receipts other than coffee was allowed. At the same time exchange bureaux were permitted to hold transactions in foreign exchange at a market rate, and there was extreme tolerance of the parallel market until its legalisation in July 1990. In effect the parallel market rate became the official rate. At the same time the authorities chose a crawling peg system introduced to maintain the real effective exchange rate constant and introduced an auction system in December 1991 (Kasekende and Ssemogerere, 1994; Kasekende and Atingi-Ego, 1999a). In the pre-reform period, domestic prices were largely determined by the parallel or *kibanda* rate, as imports were obtained through foreign exchange obtained in this same market (Tumusiime-Mutebile, 1991, p. 340). Changes in the official exchange rate, therefore, did not affect the supply and demand for dollars significantly. This meant an official devaluation had little effect on the supply and demand for foreign exchange and hence the trade balance. Businesses could obtain foreign exchange on the parallel market, but the devaluation affected them as far as the increases in transport costs, particularly increases in imported fuel (*ibid.*).

If the official exchange rate did not affect the trade balance and prices, what was the devaluation meant to achieve in the post-reform period? The argument in favour of devaluation was because it transferred resources from urban users of official foreign exchange to earners of official foreign exchange, usually the rural farmers (Ddumba-Ssentamu, *et al*, 1999).<sup>17</sup> Most important, devaluation was sought for its impact on the fiscal balance. As Mamdani (1991) notes:

“The pre-IMF dictum “print and spend” has simply been replaced by a new guideline: “borrow and spend!” Devaluation has become a budgetary substitute



for monetary financing of the deficit" (p. 352)...."For those who have argued that devaluation is the single most important instrument "to get prices right", it indeed seems strange to then turn around and argue just as vigorously that devaluation has little effect on the general level of prices under conditions of a large parallel market, the existence of which was given as reason in the first place to set "the prices right" through devaluation! But perhaps one can have one's proverbial cake and eat it too" (p. 356).

**Financial Liberalisation:** In the mainstream sense, the financial sector in Ethiopia has been repressed for most of the 1970s and 1980s. "Political lending" has been a common practice and the state used the monopoly over state banks to finance its own spending plans. Between 1970 and 1991 deposits in the saving accounts only yielded between 1-2 per cent nominal interest rates (Ayana, 1994; Mohamed, 1996).<sup>18</sup> As shown in Table 5.5, real interest rates remained negative until 1996, but showed improvement thereafter, only to reverse back to negative rates in 2000 and 2001.

**Table 5.5 – Real Interest on Time Deposit, 1985-2001**

Years	Ethiopia	Uganda
1985	-2.7	-33.5
1986	3.7	-48.7
1987	-5.0	-58.9
1988	-13.5	-50.5
1989	14.2	-38.4
1990	5.6	-3.1
1991	-3.8	7.7
1992	-6.1	--
1993	-2.1	-5.5
1994	-14.8	5.6
1995	-13.0	2.5
1996	1.8	3.9
1997	10.7	2.6
1998	-1.2	1.8
1999	6.2	7.6
2000	11.1	--
2001	-0.1	--
2002	-0.2	--

*Source: IMF Financial Statistics Electronic Database, 2002.*

Ethiopia's reforms in the financial sector in general are "evolutionary" and not "revolutionary": the state-owned Commercial Bank of Ethiopia (CBE) still holds over 75 per cent of the market share (see Peterson, 2001). The IMF constantly argues that the financial sector should be liberalised, particularly the elimination of the monopoly by the Commercial Bank of Ethiopia to enhance competition. In its reports the IMF insists that further liberalisation in the financial sector should be "pushed" and the government needs to take "genuine" actions and it continues to "urge" the government to open up the sector (IMF, 2002a and 2002b). However, the Ethiopian government insists that the financial sector remains closed from outside competition until domestic banking capacity is built (Stiglitz, 2002). The fear is the dominance of foreign banks and the likely effect on interest rates and exchange rates. What the government conceded was (a) to restructure the management of the CBE; (b) to observe strictly the reserve requirements; (c) to reduce excess liquidity and nonperforming loans; and (d) to allow auditing by an international firm (IMF, 2002a and 2002b).<sup>19</sup>

In Uganda, financial liberalisation started when interest rate controls were removed in 1993 and was completed in July 1994 (see Kasekende and Atingi-Ego, 1999a). As shown in Table 5.5, real interest rates on time deposits improved from -5.5 per cent in 1993 to 5.6 per cent in 1994. Intensive liberalisation and decline in inflation rates meant positive real interest rates from 1994 onwards. After the liberalisation of the sector, there has been rapid expansion with new banks entering the market (Harvey and Robinson, 1995; Ddumba-Ssentamu *et al.*, 1999; Henstridge, 1999; Nachega, 2001, p. 16; UN, 2001).<sup>20</sup>

### 5.3.6 Performance and Programme Completion

Section 4.8 in the previous chapter tackled the question "are IMF programmes implemented as agreed?" Answers to this question are relevant as the failure of IMF stabilisation and adjustment programmes is often explained by lack of *implementation*. Recent studies argued that failure to comply with IMF conditionality or implementing agreed policies results in worse performance. The notion is that commitment to reform

will result in proper follow-up of conditionality set by the IMF which in turn results in improved macroeconomic performance (see Mercer-Blackman and Unigovskaya, 2000). Many researchers found that compliance with IMF conditionality has been problematic and numerous programmes have not been completed as agreed (Beveridge and Kelly, 1980; Edward, 1989, 2001; Polak, 1991; Conway, 1994; Killick, 1995a; Mussa and Savastano, 1999; Mecagni, 1999). The consensus is that high rate of non-adoption is widespread and waivers and modifications may lead to overestimation or underestimation of programme effects (Goldstein, 2000, 2003; Kapur, 2001; IMF, 2001b).

According to Killick (1995a) incomplete programmes are those in which 20 per cent or more of the total credit agreed between the IMF and a country is undrawn. Mecagni's (1999) definition is that incomplete programmes are those with 6 months delay in programme reviews. As Tables 5.7 show both Ethiopia and Uganda had programmes, which were delayed by six months or more and where more than 20 per cent of the agreed amount was undrawn. Here, we set new criteria and test whether programme completion affects outcome of IMF programmes or not. Programmes are assumed incomplete when 25 per cent or more of the agreed balance is undrawn and when end of programme or expiry date is extended by ten months or more.

The first SAF in Ethiopia was completed as the entire agreed amount was withdrawn on time: no undrawn balance and no extension. Under this programme there were positive and significant changes in real per capita GDP and real GDP growth rates as well as international reserves. But no significant changes were found for inflation and the current account deficit. The ESAF programme is incomplete as 67 per cent of the agreed balance was undrawn and a 12-month extension was agreed. The results show that insignificant changes in real per capita and real GDP growth rates as well as inflation; a significant deterioration in the current account balance and international reserves. These results are consistent with the tests conducted above and demonstrate that - where programmes are not completed as agreed - the macroeconomic outcomes show no significant changes or exhibit deterioration. Where programmes are completed only the growth rates and international reserves showed positive and significant changes.

The results for Uganda show that the first SAF programme was not completed as agreed because 29 per cent of the amount was undrawn. Under this programme there were positive and significant changes in real growth of GDP per capita and real GDP growth rates, but insignificant changes were observed in inflation, current account deficits and international reserves. The second programme or the ESAF was also not completed as the programme was extended by twenty-seven months. The results show that no significant changes were observed in real growth rate of GDP per capita, real GDP growth rate, and international reserve holdings. Only the improvement in the inflation rate is statistically significant. The most recent ESAF/PGRF programme passes the completion test as the entire agreed amount has been withdrawn, albeit with two months extension of the expiry date. However, no significant changes were observed in real GDP per capita growth; real GDP growth rate; inflation and international reserves. Only a significant and positive improvement was observed in the current account deficit.

The above findings imply that even if we take account of programme completion, we only find a few statistically significant differences between completed and incomplete programmes in terms of impact on key macroeconomic variables. In Ethiopia a completed programme was associated with partial success, mainly improvement in growth rates. The incomplete ESAF had no impact on growth rates and the programme was associated with worsening external sector. For Uganda growth rates improved even though the SAF programme was not completed. The ESAF programme took three full programme years and two additional years to bring about reductions in the inflation rate. When the ESAF/PGRF was completed it only resulted in an improved external sector, but no changes were observed in the other variables.

## 5.4 Absence of Structural Transformation

Statistical significances (or otherwise) based on t-statistics do not tell us much about economic significance. The right direction in assessing economic reform programmes would be to examine how improvements in key target variables translate into tangible development outcomes. One of these outcomes is an increase in the output

share of manufacturing in national income or structural transformation. The results reported as well as those surveyed in the previous chapter fail to answer the question - *are improvements in per capita income or the rate of growth associated with structural transformation?* Impact assessments based on merely measuring the counterfactual by traditional macroeconomic performance fail to tackle the fundamental problem of development, particularly in economies heavily dependent on imports where domestic manufacturing may possibly substitute.

By “structural” then is meant a contribution to development beyond macroeconomic performance as such. It is not the intention of this chapter to examine such a notion in depth, either conceptually or empirically. This section seeks an impact evaluation that goes beyond testing statistical significance of changes in macroeconomic target and policy variables to measuring the fundamental causes of economic decline and how these have been resolved. This is done by assessing changes in the share of manufacturing in national income for both Ethiopia and Uganda. Both before-after and with-without tests are applied. The former observes changes in the share of manufacturing before and after IMF programmes and the latter evaluates changes in the share of manufacturing in both countries compared to that observed in the four countries without IMF programmes.

The results in Table 5.16 indicate that structural transformation did not take place in Ethiopia and positive but modest change was observed for Uganda. The results for Uganda indicate that the share of manufacturing in GDP increased from an average of 6.6 per cent for the period 1965-1986 to 6.8 for the period 1987-2001. However, even this meagre increment is statistically insignificant on long-term comparisons implying no difference in the structure of the Ugandan economy between the years with IMF programmes and those without. If we take out the period 1965 to 1971, the result becomes significant as the share of manufacturing in GDP increased from an average of 5.5 per cent for the period 1972-1986 to 6.8 for the period 1987-2001. The bulk of the increase in the share of manufacturing took place post 1995 when it reached 6.2 per cent - the same value that was achieved in 1982. The favourable trend is that export-oriented

manufacturing firms performed better than non-exporting firms, with an increase of 40 per cent, compared to 15 per cent for non-exporters, but not for import substituting manufacturing (Gauthier, 2001).

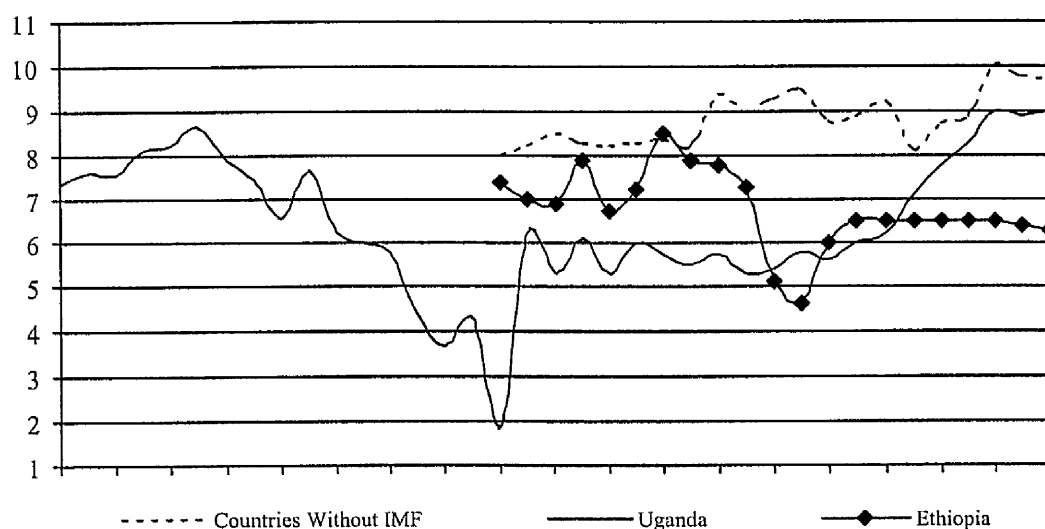
For Ethiopia the share of manufacturing in GDP *declined* from an average of 7.2 per cent for the period 1981-1991 to 6.2 for the period 1992-2001. Most importantly this change is statistically significant. The Ethiopian economy under IMF programmes de-industrialised and remains fundamentally an agrarian economy. Coffee still makes up 73 per cent of the total values of exports. The contribution of the five major export commodities, which are all agricultural (coffee, khat, hide/skins and spices), has been increasing from 74 per cent in 1991 to 95 per cent in 1998 (MEDaC, 1999).

With-without comparisons also show significant differences between Ethiopia and Uganda, on the one hand, and countries without IMF Programmes, on the other. As shown in Figure 5.1, the share of manufacturing in GDP averaged 8.8 per cent for the four countries without IMF programmes for the period 1981-2001 compared to 6.2 per cent and 6.3 per cent for Ethiopia and Uganda, respectively. Tests for the programme period, from 1992-2001, indicate that the share of manufacturing averaged 9.2 per cent for countries without IMF programmes compared to 6.3 per cent and 7.4 per cent for Ethiopia and Uganda, respectively. These findings illustrate that behind superficially alluring growth rate figures both Ethiopia and Uganda experienced no major structural transformation under IMF programmes compared to the years without programmes or compared to countries without programmes. The rationale of IMF programmes and their objectives must be questioned if they only achieve higher growth rates, reserve holdings and in some cases low inflation but not fundamental economic development.

All in all the evidence indicates that there is no sign of expansion in manufacturing activities. These findings substantiate the reservation against liberalisation in the absence of selective credit disbursement, subsidies, protection and technological transfers. If we just take one of these incentives, disbursement of bank credit, we find that little attention has been paid to its contribution to the manufacturing sector. In Ethiopia,

as Table 5.6 shows, the share of bank credit to finance imports went up from 2 per cent in 1992 to 16.3 per cent in 1998. Surprisingly, in the same period, bank credit to the export sector fell from 8.6 per cent in 1993 to 3.7 per cent in 1998, but picked up significantly for the period 1999-2002 to reach 30.5 per cent in line with the increase for international trade which went up from 7 per cent in 19992 to 38.4 per cent over 1999-2002. Credit flow to agriculture fell from 21.7 per cent in 1992 to 5.9 per cent over 1999-2002. A significant share of credit, 28 per cent, went to the domestic retail-trading sector over 1999-2002. Credit disbursements to manufacturing, however, *declined* from 28.9 per cent in 1993 to 9.8 per cent in 1998.

**Figure 5.1 Manufacturing Output as a share of GDP (Percentages - 1965-2001)**



*Source: Calculated from World Bank Africa Database CD Rome, 2003.*

In Uganda, as shown in Table 5.6, a large proportion of bank credit went to the trade sector, which averaged 45.7 per cent between 1992 and 1998. The data show that credit advanced to the agricultural sector was falling throughout the 1990s. Credit to the manufacturing sector doubled from 14.4 per cent in 1992 to 27.6 in 1998, but fell back to 21.3 percent for the years 1999-2002. The increase in credit going to the manufacturing sector is mainly linked to the return of Asian businesses, which are traditionally the pioneers of industrial capital in East Africa (Himbara, 1993). However, as the statistical

test illustrates the share of manufacturing in national income has not improved significantly. As the findings in the previous section confirm, the share of credit advanced to the export sector has been falling since 1994 from 1.6 per cent to 0.9 per cent in 1998. This is a startling statistics given the emphasis on export-led growth within the liberalisation agenda. Increasing loan disbursement to finance imports and retail trade implies that: 1) business activity focuses on quick entry and exit and not long-term commitment in manufacturing; and 2) lending is predominantly for short-term financing working capital rather than for long-term financing of investment or fixed capital formation.<sup>21</sup>

**Table 5.6 – Percentage Share of Credit by Sector in Total Bank Credit, 1992-2002**

	1992	1993	1994	1995	1996	1997	1998	1999-2002
<b>Ethiopia</b>								
Agriculture	21.7	8.5	5.3	13.8	16.2	16.9	16.7	5.9
Manufacturing	20.4	28.9	18.6	8.1	11.8	9.6	13.1	9.8
Retail Trade	27.0	25.9	42.4	37.4	36.4	31.7	23.7	28.2
International Trade	7.0	18.5	6.4	7.7	15.0	16.8	20.0	38.4
• Export	5.0	8.6	2.8	3.3	6.2	7.9	3.7	30.5
• Import	2.0	9.9	3.6	4.3	6.3	8.9	16.3	7.9
<b>Uganda</b>								
Agriculture	25.4	26.2	23.8	22.1	19.5	19.2	17.1	7.5
Manufacturing	14.4	16.8	20.9	21.8	26.7	21.7	27.6	21.3
Retail Trade	10.5	14.1	13.1	13.7	16.3	10.6	9.7	--
Trade	45.8	43.8	42.6	46.4	45.5	50.5	45.1	--
• Imports	--	--	14.3	19.1	13.3	20.7	16.7	--
• Exports	--	--	1.6	1.0	1.0	1.1	0.9	--

*Source: For Uganda IMF (1998; 1999d) and Bank of Uganda (2003). For Ethiopia Calculated from MEDaC (1999)*

## 5.5 Concluding Remarks

This chapter asked the question “does the IMF achieve its stated objectives? Survey of the empirical literature in the previous chapter concluded that the results are mixed. IMF programmes are associated with positive outcome in some variables but not all the time. This chapter answers the above question by assessing the impact of IMF programmes in Ethiopia and Uganda - two of the countries in sub-Saharan Africa, which



adopted eight IMF programmes between 1987 and 2004. The programmes prescribed various short-term stabilisation and medium-term structural reforms.

Using a mix of case study and formal statistical methods, this chapter concludes that IMF programmes did not meet their stated objectives nor are these objectives necessarily appropriate for economic development. The target variable tested included real growth of GDP per capita; real growth of GDP; the rate of inflation; current account balances; international reserve holdings as well as policy variables. The before and after method compared outcomes in target variables on both short-term and long-term basis, while the with-without approach compared Ethiopian and Uganda to countries, which did not implement IMF SAF and ESAF programmes. Tests were also carried out to examine individual effects of programmes – whether the SAF or ESAF led to better performance.

The statistical tests for the most part demonstrate that the effect of IMF programmes on real GDP per capita and real GDP growth rates is only significant in the initial three years under SAF programmes compared to the previous three years. Uganda performed better than Ethiopia under IMF programmes, particularly on longer-term comparisons. However, growth rates for both countries were no better than for countries that did not adopt IMF programmes. While Uganda reduced its high rate of inflation in the second ESAF programme after six years under IMF programme, Ethiopia shows a significant difference compared to the average for countries without IMF programmes, but Ethiopia always had historically low inflation rates.

The current account for Ethiopia and Uganda did not significantly improve under IMF programmes and in some years experienced deterioration in their deficits. In contrast IMF programmes had positive and significant impact on the reserve holdings of both countries, but these improvements are not statistically different from those observed in Botswana and the countries without IMF programmes. Countries that did not implement IMF programmes actually performed better and improved their external sectors.

Two-thirds of IMF programmes were not fully completed and the policy variables did not move in the predicted direction. The results show that no significant difference was observed in the flow of domestic credit to government or in fiscal deficits before and after programmes. IMF programmes were associated with significant real exchange rate depreciations for both Ethiopia and Uganda, while liberalisation of the financial sector in Uganda led to real positive interest rates, but not in Ethiopia. These results indicate that IMF programmes are not always *fully* implemented. Moreover, programme completion is not correlated with performance. We find cases where target variables improve even though programmes are not completed and vice-versa.

For the most part “recidivism”, *à la* Bird (2001), is practised in both Ethiopia and Uganda, but there is no discernible evidence to celebrate sustained success in the target variables. The findings conform to those in the literature that recidivism has been the standard practice in countries facing internal and external imbalances (Edwards and Santaella, 1993; Conway, 1994; Knight and Santaella, 1997; Conway, 2000; Bird, 2001; Bird *et al.*, 2002; Joyce, 2002). The rate of repetitive lending is found to be high where new programmes had to be agreed in response to failed ones. However, it has also been found elsewhere that repetitive lending does not lead to improved performance (Easterly, 2002).

The results are largely consistent with the survey of the empirical evidence in the previous chapter. There is limited and partial evidence to imply that Ethiopia and Uganda fared differently from their pre-reform economic state or performed as or better than Botswana, Namibia, Seychelles, and Sudan, which never implemented IMF SAF, ESAF and PGRF programmes. The results mean that not only IMF programmes do not work as envisaged but also their rationale must be questioned. A test of structural transformation shows that despite extensive reforms the Ethiopian economy de-industrialised while the Ugandan industrial sector stagnated. These conclusions are supported by results, which illustrate that the share of manufacturing in GDP declined by 1 per cent for Ethiopia, comparing the years with IMF programmes to those without. The 1 per cent increment for Uganda is significant only when compared to 1981, when the share of manufacturing was

1.9 per cent. At 9 per cent of GDP the share of manufacturing in 1970 is equal to that for 2001.

This chapter's contribution is both in assessing the impact of IMF programmes in Ethiopia and Uganda as well as in testing whether the positive effects are meaningful or not. The conclusion is that IMF programmes were associated with immediate improvements in real GDP; per capita GDP growth rates; and reserve holdings, but there is little evidence to advocate that IMF programmes meet all their objectives. Ethiopia and Uganda implemented IMF programmes at a particular point in time where both emerged out of civil wars and low level of growth rates. It would be difficult to ascribe improvements in these variables to IMF programmes. But this is a moot point. One could argue that economic reforms, that may well improve growth rates, would have been adopted in some form or another.

More to the point both countries failed to transform their economies structurally, mainly because the theoretical foundation of IMF programmes has set aside the developmental role of the state. Structural transformations occurred in other parts of the world, particularly East Asia as a direct result of state intervention to guide structural transformation. The next chapter argues the missing link in countries such as Ethiopia and Uganda is the developmental state, which would mobilise finances, and create state-society relations that allowed for selective credit, subsidies, protection, and other industrial policies.

# Appendix 5.1

Table 5.7 - IMF Lending Arrangements to Ethiopia and Uganda, 1981-2005

Country	Type	Date		Amount		Expiration Date	Amount		Undrawn Balance (SDR m)	Undrawn Balance (%)	Period of Extension (Months)
		Approved	Date	Approved	(SDR m)		Purchased	(SDR m)			
Ethiopia	SB	05-Aug-81		67.50		30-Jun-82	44.00		23.50	35	n/a
	SAF	28-Oct-92		49.42		08-Nov-95	49.42		0.00	0	0
	ESAF	11-Oct-96		88.47		22-Oct-99	29.49		58.98	67	12
	PGRF	22-Mar-01		100.28		31-Jul-04	89.85		10.43	10	4
Uganda	SB	06-May-81		112.50		30-Jun-82	77.50		35.00	31	n/a
	SB	08-Nov-82		112.50		18-Aug-83	112.50		0.00	0	n/a
	SB	16-Sep-83		95.00		15-Sep-84	65.00		30.00	32	n/a
	SAF	15-Jun-87		69.72		14-Jun-90	49.80		19.92	29	0
	ESAF	17-Apr-89		219.12		30-Jun-94	219.12		0.00	0	27
	ESAF	06-Sep-94		120.51		09-Nov-97	120.51		0.00	0	2
	PRGF	10-Nov-97		100.43		31-Mar-01	100.43		0.00	0	5
	PGRF	13-Sep-02		13.50		12-Sep-05	1.50		12.00	89	n/a

Source: Calculated from IMF Survey, Various Issues

Table 5.8 Ethiopia: Short-term Before-After Comparisons for Target Variables under Mann-Whitney U-test

Real GDP Per Capita Growth Rate

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Ethiopia	1990-1992	1993-1998	6	3	17	17	0.0476	0.0389	-5.81	4.12	0	0	Significant: Accept $H_A$
	1994-1996	1997-2001	5	3	15	10	0.5714	0.4561	3.64	1.93	67	12	Not Significant: Accept $H_0$

Real GDP Growth Rate

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Ethiopia	1990-1992	1993-1998	6	3	17	17	0.0476	0.0389	-2.46	6.27	0	0	Significant: Accept $H_A$
	1994-1996	1997-2001	5	3	15	10	0.5714	0.4560	6.74	4.45	67	12	Not Significant: Accept $H_0$

Inflation

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Ethiopia	1990-1992	1993-1998	6	3	17	16	0.0952	0.0707	17.13	3.51	0	0	Not Significant: Accept $H_0$
	1994-1996	1997-2001	5	3	15	10	0.5714	0.456	4.18	1.08	67	12	Not Significant: Accept $H_1$

Current Account

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Ethiopia	1990-1992	1993-1998	6	3	17	11	0.7143	0.6056	-1.53	-0.32	0	0	Not Significant: Accept $H_3$
	1994-1996	1997-2001	5	3	15	15	0.0357	0.0253	1.53	-4.00	67	12	Significant: Accept $H_A$

Reserves

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Ethiopia	1990-1992	1993-1998	6	3	17	18	0.0238	0.0201	1.5	5.4	0	0	Significant: Accept $H_A$
	1994-1996	1997-2001	5	3	15	15	0.0357	0.0253	6.7	3.3	67	12	Significant: Accept $H_A$

Table 5.8 Continued.....

Growth of Net Domestic Credit to Government

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Ethiopia	1990-1992	1993-1998	6	3	17	15	0.01667	0.1213	-23.43	325.90	0	0	Not Significant: Accept $H_2$
	1994-1996	1997-2001	5	3	15	8	0.9999	0.8815	95.97	303.56	67	12	Not Significant: Accept $H_3$

Overall Deficit

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Ethiopia	1990-1992	1993-1998	6	3	17	16	0.0952	0.0707	-10.83	-7.95	0	0	Not Significant: Accept $H_2$
	1994-1996	1997-2001	5	3	15	8	0.9999	0.8815	-8.967	-10.18	67	12	Not Significant: Accept $H_3$

Real Effective Exchange Rate

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Ethiopia	1990-1992	1993-1998	6	3	17	18	0.0238	0.0201	102.51	37.94	0	0	Significant: Accept $H_A$
	1994-1996	1997-2001	5	3	15	13	0.1429	0.1011	37.27	34.39	67	12	Not Significant: Accept $H_3$

Real Interest Rates

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Ethiopia	1985-1993	1994-2002	9	9	64	49	0.4894	0.4529	-1.08	0.06			Not Significant: Accept $H_3$

Table 5.9 Uganda: Short-term Before-After Comparisons for Target Variables under Mann-Whitney U-test

Real GDP Growth Rate

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Uganda	1985-1987	1988-1993	6	3	17	17	0.0476	0.0389	0.35	6.40	29	0	Significant: Accept $H_A$
	1987-1989	1990-1997	8	3	22	15	0.6303	0.5403	6.20	6.94	0	27	Not Significant: Accept $H_0$
	1992-1994	1995-2001	7	3	20	12	0.8333	0.7324	6.05	6.66	0	2	Not Significant: Accept $H_0$

Real GDP Per Capita Growth Rate

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Uganda	1985-1987	1988-1993	6	3	16	17	0.0476	0.0389	-1.92	2.99	29	0	Significant: Accept $H_A$
	1987-1989	1990-1997	8	3	22	13	0.9212	0.8383	3.17	3.54	0	27	Not Significant: Accept $H_0$
	1992-1994	1995-2001	7	3	20	12	0.8333	0.7324	2.65	3.63	0	2	Not Significant: Accept $H_1$

Inflation

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Uganda	1985-1987	1988-1993	6	3	17	16	0.0952	0.0707	172.89	62.88	29	0	Not Significant: Accept $H_3$
	1987-1989	1990-1997	8	3	22	24	0.0121	0.0143	152.53	19.02	0	27	Significant: Accept $H_A$
	1992-1994	1995-2001	7	3	20	17	0.1833	0.1385	22.75	4.84	0	2	Not Significant: Accept $H_3$

Current Account

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Uganda	1985-1987	1988-1993	6	3	17	12	0.5476	0.4386	-1.73	-8.55	29	0	Not Significant: Accept $H_3$
	1987-1989	1990-1997	8	3	22	18	0.2788	0.2207	-0.60	-11.25	0	27	Not Significant: Accept $H_4$
	1992-1994	1995-2001	7	3	20	21	0.0167	0.0167	-23.87	-5.50	0	2	Significant: Accept $H_A$

Reserves

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Uganda	1985-1987	1988-1993	6	3	17	12	0.5169	0.4386	0.8	1.1	29	0	Not Significant: Accept $H_0$
	1987-1989	1990-1997	8	3	22	21	0.0659	0.0662	2.9	0.7	0	27	Not Significant: Accept $H_1$
	1992-1994	1995-2001	7	3	20	19	0.0667	0.0527	2.8	5.5	0	2	Not Significant: Accept $H_3$

Table 5.9 Continued.....

Growth of Net Domestic Credit to Government

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Uganda	1985-1987	1988-1993	6	3	17	14	0.2619	0.1967	-1188.80	-24145.00	29	0	Not Significant: Accept $H_3$
	1987-1989	1990-1997	8	3	22	13	0.9212	0.8383	871.65	-18630.00	0	27	Not Significant: Accept $H_6$
	1992-1994	1995-2001	7	3	20	14	0.5167	0.4250	-50455.00	-299.81	0	2	Not Significant: Accept $H_7$

Overall Deficit

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Uganda	1985-1987	1988-1993	6	3	17	18	0.0238	0.0201	-4.30	-8.27	29	0	Significant: Accept $H_A$
	1987-1989	1990-1997	8	3	22	24	0.0121	0.0143	-4.87	-8.51	0	27	Significant: Accept $H_A$
	1992-1994	1995-2001	7	3	20	17	0.1833	0.1385	-12.00	-7.97	0	2	Not Significant: Accept $H_3$

Real Effective Exchange Rate

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Uganda	1985-1987	1988-1993	6	3	17	15	0.1667	0.1213	201.63	126.01	29	0	Not Significant: Accept $H_3$
	1987-1989	1990-1997	8	3	22	24	0.0121	0.0143	213.60	95.43	0	27	Significant: Accept $H_A$
	1992-1994	1995-2001	7	3	20	15	0.3833	0.3051	87.09	97.897	0	2	Not Significant: Accept $H_3$

Real Interest Rates

Countries	Period		$\eta_1$	$\eta_2$	$U_{critic}$	$U_{calc}$	P value (two-tailed)	Z value (two-tailed)	Mean Values		Undrawn Balance (%)	Extension Months	Result At 95 % Confidence Interval
	Before	After							Before	After			
Uganda	1985-1993	1994-1999	9	6	44	49	0.0076	0.0095	-29.34	4.25			Significant: Accept $H_A$



Table 5.10 Ethiopia: Statistical Results for Long-Term Comparisons under Before-After Comparisons: Years Before and After IMF Programmes

Real GDP Per Capita Growth		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnnett 95% CI
With IMF	With IMF	10	2.88	6.55	2.070	IMF		146.88	1	146.88	2.35	0.1446	With IMF v Without IMF	5.75	-2.20 to 13.69
	Without IMF	8	-2.87	9.36	3.309	Within cells		998.88	16	62.43					(insignificant)
	Total					Total		1145.76	17						
Real Growth of GDP		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnnett 95% CI
With IMF	With IMF	10	5.07	5.31	1.678	IMF		78.23	1	78.23	1.46	0.2428	With IMF v Without IMF	3.96	-2.92 to 10.83
	Without IMF	10	1.12	8.90	2.813	Within cells		965.52	18	53.64					(insignificant)
	Total					Total		1043.75	19						
Inflation		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnnett 95% CI
With IMF	With IMF	9	2.39	5.98	1.992	IMF		200.45	1	200.45	1.99	0.1770	With IMF v Without IMF	-6.67	-16.69 to 3.34
	Without IMF	9	9.06	12.86	4.285	Within cells		1608.08	16	100.51					(insignificant)
	Total					Total		1808.54	17						
CA Balance		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnnett 95% CI
With IMF	With IMF	10	-1.84	3.53	1.115	IMF		0.04	1	0.04	0.00	0.9326	With IMF v Without IMF	0.09	-3.04 to 3.21
	Without IMF	8	-1.93	2.47	0.874	Within cells		154.58	16	9.66					(insignificant)
	Total					Total		154.62	17						
Reserves		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnnett 95% CI
With IMF	With IMF	10	4.39	1.76	0.556	IMF		34.52	1	34.52	16.70	0.0009	With IMF v Without IMF	2.79	1.34 to 4.23
	Without IMF	8	1.60	0.87	0.306	Within cells		33.08	16	2.07					(significant)
	Total					Total		67.60	17						
Flow of Domestic Credit to Govt.		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnnett 95% CI
With IMF	With IMF	9	202.17	530.18	176.726	IMF		332.74	1	332.74	2.30	0.1481	With IMF v Without IMF	265.04	-104.05 to 634.12
	Without IMF	10	-62.87	154.62	48.897	Within cells		2463.90	17	144.94					(insignificant)
	Total					Total		2796.64	18						
Overall Deficit		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnnett 95% CI
With IMF	With IMF	10	-9.51	2.79	0.883	IMF		0.00	1	0.00	0.00	0.9979	With IMF v Without IMF	0.00	-2.34 to 2.35
	Without IMF	11	-9.51	2.34	0.706	Within cells		124.98	19	6.58					(insignificant)
	Total					Total		124.98	20						
Real Exchange Rate		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnnett 95% CI
With IMF	With IMF	10	42.72	20.03	6.334	IMF		17564.18	1	17564.18	45.39	<0.0001	With IMF v Without IMF	-65.31	-85.96 to -44.66
	Without IMF	7	108.03	19.12	7.226	Within cells		5804.47	15	386.96					(significant)
	Total					Total		23368.65	16						

^ = thousands

Table 5.11 Uganda: Statistical Results for Long-Term Comparisons under Before-After Comparisons: Years Before and After IMF Programmes

Real GDP per capita growth															
Years With IMF		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
Within cells		15	3.18	2.16	0.559	IMF		65.85	1	65.85	10.42	0.0049	With IMF v Without IMF	4.57	1.58 to 7.55
Total		4	-1.39	3.74	1.868	Within cells		107.43	17	6.32					
Years Without IMF						Total		173.28	18						
Real Growth Rate of GDP															
With IMF		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
Within cells		15	6.36	2.27	0.587	IMF		103.91	1	103.91	15.37	0.0011	With IMF v Without IMF	5.74	2.65 to 8.82
Total		4	0.62	3.77	1.885	Within cells		114.93	17	6.76					
Without IMF						Total		218.84	18						
Inflation															
With IMF		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
Within cells		15	41.40	66.30	17.118	IMF		10364.38	1	10364.38	2.47	0.1326	With IMF v Without IMF	-49.18	-114.58 to 16.23
Total		6	90.57	60.35	24.636	Within cells		79744.99	19	4197.10					
Without IMF						Total		90109.37	20						
CA Balance															
With IMF		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
Within cells		15	-7.25	9.37	2.418	IMF		18.21	1	18.21	0.23	0.6403	With IMF v Without IMF	1.95	-6.65 to 10.56
Total		7	-9.20	8.06	3.048	Within cells		1618.20	20	80.91					
Without IMF						Total		1636.41	21						
Reserves															
With IMF		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
Within cells		15	3.35	2.40	0.619	IMF		23.03	1	23.03	5.46	0.0299	With IMF v Without IMF	2.20	0.23 to 4.16
Total		7	1.16	0.79	0.300	Within cells		84.27	20	4.21					
Without IMF						Total		107.30	21						
Flow of Domestic Credit to Govt.															
With IMF		n	Mean	SD	SE	Source of variation		SSq*	DF	MSq*	F	p	Contrast	Difference	Dunnett 95% CI
Within cells		15	-10031.76	39189.99	10118.812	IMF		404.11	1	404.11	0.36	0.5572	With IMF v Without IMF	-9710.41	-43674.56 to 24253.74
Total		6	-321.35	685.73	279.948	Within cells		121504.33	19	1131.81					
Without IMF						Total		21908.43	20						
Overall Deficit															
With IMF		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
Within cells		15	-7.98	3.37	0.871	IMF		43.77	1	43.77	4.34	0.0535	With IMF v Without IMF	-4.18	-8.44 to 0.07
Total		3	-3.80	0.99	0.572	Within cells		161.18	16	10.07					
Without IMF						Total		204.94	17						
Real Exchange Rate															
With IMF		n	Mean	SD	SE	Source of variation		SSq^	DF	MSq^	F	p	Contrast	Difference	Dunnett 95% CI
Within cells		15	118.85	51.03	13.175	IMF		345.24	1	345.24	9.03	0.0070	With IMF v Without IMF	-268.95	-455.99 to -81.92
Total		7	387.80	348.33	131.656	Within cells		764.45	20	38.22					
Without IMF						Total		1109.69	21						

\* = in thousands,  
\* = in millions

Table 5.12 Ethiopia: Statistical Results under Before-After for Individual Programme Comparisons

Real GDP Per Capita Growth		n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
ESAF	ESAF	6	2.84	3.69	1.506	IMF	146.91	2	73.45	1.10	0.3573	ESAF v None	5.71	-5.04 to 16.46
	None	8	-2.87	9.36	3.309	Within cells	998.85	15	66.59			SAF v None	5.81	-6.38 to 18.00
	SAF	4	2.94	10.29	5.145	Total	1145.76	17						
Real Growth Rate of GDP		n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
ESAF	ESAF	6	5.48	3.89	1.589	IMF	103.91	2	51.96	0.85	0.4453	ESAF v None	5.19	-5.09 to 15.46
	None	8	0.30	9.72	3.437	Within cells	912.34	15	60.82			SAF v None	4.16	-7.49 to 15.82
	SAF	4	4.46	7.64	3.820	Total	1016.25	17						
Inflation		n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
ESAF	ESAF	6	0.05	5.77	2.355	IMF	298.46	2	149.23	1.48	0.2586	ESAF v None	-9.01	-21.91 to 3.90
	None	9	9.06	12.86	4.285	Within cells	1510.08	15	100.67			SAF v None	-2.01	-18.33 to 14.31
	SAF	3	7.05	3.27	1.890	Total	1808.54	17						
CA Balance		n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
ESAF	ESAF	6	-3.11	3.88	1.583	IMF	24.39	2	12.20	1.40	0.2759	ESAF v None	-1.19	-5.07 to 2.70
	None	8	-1.93	2.47	0.874	Within cells	130.22	15	8.68			SAF v None	2.00	-2.40 to 6.40
	SAF	4	0.07	2.02	1.012	Total	154.62	17						
Reserves		n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
ESAF	ESAF	6	3.93	1.65	0.673	IMF	37.71	2	18.85	9.46	0.0022	ESAF v None	2.33	0.47 to 4.19
	None	8	1.60	0.87	0.306	Within cells	29.90	15	1.99			SAF v None	3.48	1.37 to 5.59
	SAF	4	5.08	1.92	0.960	Total	67.60	17						
Flow of Domestic Credit to Govt.		n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
ESAF	ESAF	6	246.85	660.63	269.702	IMF	357.49	2	178.74	1.17	0.3348	ESAF v None	314.48	-183.51 to 812.47
	None	9	-67.64	163.22	54.408	Within cells	2439.15	16	152.45			SAF v None	147.25	-420.55 to 715.05
	SAF	4	79.62	120.88	60.440	Total	2796.64	18						
Overall Deficit		n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
ESAF	ESAF	6	-9.91	3.40	1.389	IMF	2.45	2	1.23	0.18	0.8366	ESAF v None	-0.40	-3.58 to 2.78
	None	11	-9.51	2.34	0.706	Within cells	122.53	18	6.81			SAF v None	0.61	-3.05 to 4.27
	SAF	4	-8.90	1.82	0.908	Total	124.98	20						
Real Exchange Rate		n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
ESAF	ESAF	6	34.55	1.45	0.590	IMF	18563.19	2	9281.60	27.04	<0.0001	ESAF v None	-73.47	-98.83 to -48.12
	None	7	108.03	19.12	7.226	Within cells	4805.46	14	343.25			SAF v None	-53.07	-81.64 to -24.50
	SAF	4	54.96	29.45	14.724	Total	23368.65	16						

^ = thousands

Table 5.13 Uganda: Statistical Results under Before-After for Individual Programme Comparisons

Real GDP per capita growth															
	ESAF	n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
	None	11	3.21	2.41	0.725	IMF	65.90	2	32.95	4.91	0.0217	ESAF v None		4.60	(significant)
	SAF	4	-1.39	3.74	1.868		107.38	16	6.71	SAF v None		4.47	(significant)		
		4	3.08	1.60	0.798		Total	173.28	18						
Real Growth Rate of GDP															
	ESAF	n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
	None	11	6.39	2.51	0.756	IMF	103.95	2	51.98	7.24	0.0058	ESAF v None		5.77	(significant)
	SAF	4	0.62	3.77	1.885		114.89	16	7.18	SAF v None		5.65	(significant)		
		4	6.27	1.77	0.883		Total	218.84	18						
Inflation															
	ESAF	n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
	None	11	11.84	15.34	4.626	IMF	46400.18	2	23200.09	9.55	0.0015	ESAF v None		-78.73	(significant)
	SAF	6	90.57	60.35	24.636		43709.19	18	2428.29	SAF v None		32.10	(insignificant)		
		4	122.68	87.84	43.920		Total	90109.37	20						
C.A Balance															
	ESAF	n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
	None	11	-9.73	9.86	2.974	IMF	272.04	2	136.02	1.89	0.1778	ESAF v None		-0.53	(insignificant)
	SAF	7	-9.20	8.06	3.048		1364.37	19	71.81	SAF v None		8.78	(insignificant)		
		4	-0.43	0.57	0.287		Total	1636.41	21						
Reserves															
	ESAF	n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
	None	11	4.33	2.03	0.612	IMF	61.97	2	30.98	12.99	0.0003	ESAF v None		3.17	(significant)
	SAF	7	1.16	0.79	0.300		45.33	19	2.39	SAF v None		-0.48	(insignificant)		
		4	0.68	0.34	0.168		Total	107.30	21						
Flow of Domestic Credit to Govt.															
	ESAF	n	Mean	SD	SE	Source of variation		SSq*	DF	MSq*	F	p	Contrast	Difference	Dunnett 95% CI
	None	12	-12.76	44	12.6163	IMF	849.92	2	424.96	0.36	0.7004	ESAF v None		-12.44	(insignificant)
	SAF	6	-321.35	0.69	279.9481		21058.51	18	1169.92	SAF v None		1.19	(insignificant)		
		3	871.65	4.78	2.7606		Total	21908.43	20						
Overall Deficit															
	ESAF	n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
	None	12	-8.77	3.32	0.959	IMF	80.56	2	40.28	4.86	0.0236	ESAF v None		-4.97	(significant)
	SAF	3	-3.80	0.99	0.572		124.38	15	8.29	SAF v None		-1.05	(insignificant)		
		3	-4.85	0.69	0.396		Total	204.94	17						
Real Exchange Rate															
	ESAF	n	Mean	SD	SE	Source of variation		SSq^	DF	MSq^	F	p	Contrast	Difference	Dunnett 95% CI
	None	12	95.16	10.53	3.041	IMF	378.91	2	189.46	4.93	0.0189	ESAF v None		-292.64	(significant)
	SAF	7	387.80	348.33	131.656		730.78	19	38.46	SAF v None		-174.20	(insignificant)		
		3	213.60	27.92	16.171		Total	1109.69	21						

^ = in thousands

\* = in millions

Table 5.14 Statistical Results for With-Without Comparisons: Botswana v Ethiopia/Uganda

Real GDP per capita growth		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI	
Botswana Ethiopia Uganda	Botswana	10	2.64	2.57	0.813	Countries Within cells Total	Countries	2.51	2	1.26	0.07	0.9347	Ethiopia v Botswana Uganda v Botswana	0.24	-4.29 to 4.77	(insignificant)
	Ethiopia	10	2.88	6.55	2.070		Within cells	501.51	27	18.57				0.70	-3.83 to 5.23	(insignificant)
	Uganda	10	3.34	2.50	0.791		Total	504.03	29							
Real Growth Rate of GDP		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI	
Botswana Ethiopia Uganda	Botswana	10	5.24	2.02	0.638	Countries Within cells Total	Countries	11.69	2	5.85	0.45	0.6434	Ethiopia v Botswana Uganda v Botswana	-0.17	-3.97 to 3.62	(insignificant)
	Ethiopia	10	5.07	5.31	1.678		Within cells	352.07	27	13.04				1.23	-2.56 to 5.03	(insignificant)
	Uganda	10	6.47	2.63	0.831		Total	363.76	29							
Inflation		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI	
Botswana Ethiopia Uganda	Botswana	10	9.99	3.14	0.994	Countries Within cells Total	Countries	318.00	2	159.00	1.72	0.1985	Ethiopia v Botswana Uganda v Botswana	-6.79	-16.90 to 3.32	(insignificant)
	Ethiopia	10	3.20	6.20	1.959		Within cells	2498.99	27	92.56				0.22	-9.89 to 10.33	(insignificant)
	Uganda	10	10.22	15.15	4.790		Total	2817.00	29							
Current Account Balance		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI	
Botswana Ethiopia Uganda	Botswana	10	8.53	3.38	1.070	Countries Within cells Total	Countries	1481.87	2	740.94	70.63	<0.0001	Ethiopia v Botswana Uganda v Botswana	-13.79	-17.19 to -10.38	(significant)
	Ethiopia	10	-5.26	3.30	1.043		Within cells	283.22	27	10.49				-15.82	-19.23 to -12.42	(significant)
	Uganda	10	-7.29	3.02	0.955		Total	1765.09	29							
Reserves		n	Mean	SD	SE	Source of variation		SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI	
Botswana Ethiopia Uganda	Botswana	10	23.35	1.82	0.574	Countries Within cells Total	Countries	2363.99	2	1182.00	369.76	<0.0001	Ethiopia v Botswana Uganda v Botswana	-18.97	-20.85 to -17.09	(significant)
	Ethiopia	10	4.39	1.76	0.556		Within cells	86.31	27	3.20				-18.69	-20.57 to -16.81	(significant)
	Uganda	10	4.66	1.79	0.566		Total	2450.30	29							

Table 5.15 Statistical Results for With-Without Comparisons: Botswana/Namibia/Seychelles/Sudan v Ethiopia/Uganda

Per capita growth	n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
Without IMF	10	1.91	1.22	0.384	Countries	10.60	2	5.30	0.31	0.7330	ries Without IMF	0.97	-3.35 to 5.28
Ethiopia	10	2.88	6.55	2.070	Within cells	455.34	27	16.86			Uganda v Countries Without IMF	1.43	-2.89 to 5.74
Uganda	10	3.34	2.50	0.791	Total	465.94	29						
Real GDP growth	n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
Without IMF	10	4.11	1.37	0.434	Countries	28.15	2	14.07	1.14	0.3337	ries Without IMF	0.96	-2.73 to 4.65
Ethiopia	10	5.07	5.31	1.678	Within cells	332.39	27	12.31			Uganda v Countries Without IMF	2.36	-1.33 to 6.05
Uganda	10	6.47	2.63	0.831	Total	360.54	29						
Inflation	n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
Without IMF	10	21.31	13.19	4.172	Countries	1656.64	2	833.32	5.66	0.0089	ries Without IMF	-18.11	-30.86 to -5.35
Ethiopia	10	3.20	6.20	1.959	Within cells	3976.75	27	147.29			Uganda v Countries Without IMF	-11.09	-23.84 to 1.66
Uganda	10	10.22	15.15	4.790	Total	5643.39	29						
Current Account	n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
Without IMF	10	-4.07	1.52	0.481	Countries	53.22	2	26.61	3.58	0.0419	ries Without IMF	-1.19	-4.06 to 1.68
Ethiopia	10	-5.26	3.30	1.043	Within cells	200.94	27	7.44			Uganda v Countries Without IMF	-3.23	-6.09 to -0.36
Uganda	10	-7.29	3.02	0.955	Total	254.16	29						
ries by Countries	n	Mean	SD	SE	Source of variation	SSq	DF	MSq	F	p	Contrast	Difference	Dunnett 95% CI
Without IMF	10	6.52	0.54	0.170	Countries	27.00	2	13.50	6.16	0.0063	ries Without IMF	-2.14	-3.69 to -0.58
Ethiopia	10	4.39	1.76	0.556	Within cells	59.20	27	2.19			Uganda v Countries Without IMF	-1.86	-3.42 to -0.31
Uganda	10	4.66	1.79	0.566	Total	86.20	29						

Table 5.16 Statistical Results for Long-Term Test under Before-After Comparisons for Structural Transformation

Uganda 1																	
Manufacturing as share of GDP																	
With IMF	Without IMF	n	Mean	SD	SE	Source of variation			SSq	DF	MSq	F	p	Contrast	Dunnett 95% CI	(insignificant)	
		15	6.77	1.45	0.374	IMF			2.14	1	2.14	0.84	0.3648				
		22	6.28	1.69	0.359	Within cells			89.02	35	2.54						
		Total				Total			91.16	36							
Uganda 2																	
Manufacturing as share of GDP																	
With IMF	Without IMF	n	Mean	SD	SE	Source of variation			SSq	DF	MSq	F	p	Contrast	Dunnett 95% CI	(significant)	
		15	6.77	1.45	0.374	IMF			11.78	1	11.78	5.47	0.0267				
		15	5.52	1.49	0.384	Within cells			60.31	28	2.15						
		Total				Total			72.09	29							
Ethiopia																	
Manufacturing as share of GDP (%) by IMF																	
With IMF	Without IMF	n	Mean	SD	SE	Source of variation			SSq	DF	MSq	F	p	Contrast	Dunnett 95% CI	(significant)	
		10	6.23	0.60	0.190	IMF			5.34	1	5.34	9.16	0.0069				
		11	7.24	0.88	0.267	Within cells			11.06	19	0.58						
		Total				Total			16.40	20							
Ethiopia and Uganda																	
Manufacturing as share of GDP																	
Countries without IMF	Ethiopia	Uganda	n	Mean	SD	SE	Source of variation			SSq	DF	MSq	F	p	Contrast	Dunnett 95% CI	(significant)
			21	8.83	0.61	0.133	Countries			76.53	2	38.26	29.59	<0.0001			
			21	6.76	0.91	0.198	Within cells			77.58	60	1.29					
		Total				Total			154.10	62							
Ethiopia and Uganda																	
Manufacturing as share of GDP																	
Countries without IMF	Ethiopia	Uganda	n	Mean	SD	SE	Source of variation			SSq	DF	MSq	F	p	Contrast	Dunnett 95% CI	(significant)
			10	9.15	0.58	0.183	Countries			42.26	2	21.13	23.61	<0.0001			
			11	6.34	0.67	0.201	Within cells			25.06	28	0.89					
		Total				Total			67.31	30							

## Notes

<sup>1</sup> Uganda's economic programme under the NRM is a post-conflict recovery from a civil war in the first half of the 1980s, which destroyed assets; disrupted transaction and contract enforcements; and diverted government expenditure to unproductive sectors (Collier and Hoeffler, 2000; Collier and Reinikka, 2001a).

<sup>2</sup> In Uganda poor macroeconomic performance was tolerated due to political considerations, mainly related to regional stability (Dijkstra and Donge, 2001; Adam and Gunning, 2002).

<sup>3</sup> The *Dergue's* (1974-1991) radical reforms began with nationalisation of rural land, privately owned industrial establishments, financial institutions, urban land and houses (see IDS, 1994 and Minas, 1994). In 1984 and 1985, Ethiopia suffered from a severe drought and the forced conscription of many young Ethiopians into the armed forces significantly affected the rural labour force (see Wolde Giorgis, 1989; Tirunch, 1993; Hansson, 1995). The *Dergue's* "*dirigiste*" strategy favoured control of prices through marketing boards, overvalued the exchange rate, price controls, repressed interest rates, and import-substitution (see Abegaz, 1994c, 1999).

<sup>4</sup> The 1981 IMF Stand-by programme in Ethiopia was abandoned with 35 per cent of the approved amount undrawn (see Table 5.7). In 1990, the *Dergue*, by its own volition, attempted to reverse the decline in the economy by announcing a series of new measures (Hansson, 1995). The reforms began when the *Dergue* acknowledged its weaknesses and announced a "mixed economy". The new measures, though short-lived, focused on private sector participation and abolition of producer cooperatives and marketing parastatals, but fell short of trade liberalisation, devaluation, financial liberalisation and privatisation (Hansson, 2001).

<sup>5</sup> See the papers by Goldstein and Montiel (1986) and Khan and Ul Haque (1998) for alternative versions of impact assessment models.

<sup>6</sup> The international coffee boom in the mid 1990s helped Uganda achieve the biggest reduction in poverty, particularly in the coffee-growing regions (Henstridge and Kasekende, 2001). The average life expectancy has fallen because of HIV/AIDS, while there is now improvement in the prevalence rate (MFPED, 2000). A large proportion of the population consumes less than is required to meet basic needs of life (MFPED, 2001a). Uganda's Human Development Index (HDI) at 0.435 is also categorized as one of the 24 low cases. According to the 2001 Poverty Status Report (MFPED, 2001a) real per capita consumption for the top deciles increased by 20 per cent while for the poorest deciles it only rose by 8 per cent.

<sup>7</sup> The maximum inflation rate, since the Consumer Price Index statistics began, was 28.5 per cent in 1976.

<sup>8</sup> The maximum tariff rate in Uganda currently is 15 per cent on consumer goods, and there are only two other tariff bands: zero for capital goods and 7 per cent for intermediate imports (Collier and Reinikka, 2001a). As Collier and Reinikka (p. 33) argue "taxing imports had an offsetting effect on the value of the foreign exchange. As a result, the government ended up paying the import tax itself by getting less for its sale of foreign currency."



<sup>9</sup> The government benefited through increased taxes from import duties as well as from sectors that use imported inputs (see Tanzi, 1989b). However, the dependence of public finances on import taxes driven by increased import-support and the fluctuations in donor finance meant the government resorts to deficit financing in cases of reduced support (Kasekende and Ssemogerere, 1994). See WTO (1995) for early trade policy in Uganda.

<sup>10</sup> The increase in imports since 1996 is a result of increases in *franco valuta* imports of cars; spare parts; garments and other consumer goods: the share of *franco valuta* imports increased from 32.1 per cent in 1988/89 to 53.6 per cent in 1991/92 and to 42.7 per cent in 1993/94 (Abraha, 1996).

<sup>11</sup> It is only in 1999 that the government was able to use monetary instruments to control inflation. By this time conditions exhibited improved excess liquidity position; improved financial depth; and emergence of a secondary market for Treasury Bills in 1997 (Henstridge, 1999; Henstridge and Kasekende, 2001).

<sup>12</sup> The *Dergue* relied very much not on explicit tax revenues, but various forms of non-tax revenues, which included employee contributions for the war and famine; implicit taxation of agriculture through price regulation and exchange rate overvaluation; and profit from public enterprises (Bevan and Pradhan, 1994; Bevan, 2003). Deficit financing has taken the form of borrowing from the domestic banking system, effectively from the state-owned commercial bank in the form of Treasury Bills and bonds as well and from the National Bank of Ethiopia (NBE) in the form of direct advances (Ghebre, 1994; Mulat, 1994).

<sup>13</sup> The auction market has improved the allocation of foreign exchange by increasing supply of foreign exchange to the private sector narrowing of the spread between the highest and lowest bids; reducing in the negative imports list; and diminishing margin between the parallel (Warner, 1996).

<sup>14</sup> Towards the end of the *Dergue* rule and in the first year of EPRDF, unofficial transactions, particularly smuggling had been rife and much of the economy was operating underground (Dercon and Ayalew, 1995; Abraha, 1996). Prices already reflected what went on in the illegal trade and when official devaluation was announced little changed (Hansson, 1995). The fear was that devaluation would be inflationary because of high import prices and indirectly through increased demand by the tradable sector as well as due to output contraction (Degefe and Moges, 1994).

<sup>15</sup> As noted by Kibret (1994, p. 112);

“the difference in elasticities between the demand for imports and exports; quantity imported is elastic with respect to income and the real exchange rate but inelastic with respect to import prices; quantity exported, on the other hand, is inelastic with respect to world income and real exchange rates but close to unity with respect to price in all the estimated equations; therefore, devaluation affects imports more than exports”

<sup>16</sup> The private sector invests mainly in the agricultural sector and faces fluctuations in the terms of trade. For instance, the number of coffee washing stations increased from 165 in 1992 to 480 in 1998 (IMF, 1999a).

<sup>17</sup> Jamal (1991, p. 329) notes “[I]n such a context the conventional ratios of border prices to producer prices or actual figures of export taxes fail to reflect the true state of taxation. What the government was doing was to squeeze the farmers by letting Uganda inflation diverge from imported inflation while defending the exchange rate.”

<sup>18</sup> The financial sector is not yet competitive and the legal as well as the institutional framework is still underdeveloped. Banks still prefer to hedge risk not by varying interest rates but by seeking valuable collateral such as businesses, real estate and residential houses (Ayana, 1994).

<sup>19</sup> In April 2002 the IMF went further in organising a workshop on “*The Development of the Financial Sector in Ethiopia: the Issue of Competition*”. Representatives made presentations from Kenya, Tanzania, and Uganda (its star pupil) who emphasised that liberalisation of the financial sector brought competition, stronger capitalisation of the banking sector, more diversified lending, and more efficient financial intermediation.

<sup>20</sup> Between 1990 and 1995 10 commercial banks were established. However, most banks failed to sustain their operation and four banks were closed in 1999. The share of assets and deposits changed and by 1999 private domestic owned banks accounted for 25 per cent of the market share followed by 52 per cent foreign banks and 23 per cent state owned banks. Currently the foreign banks account for 75 per cent of the market share (IMF, 1999; Henstridge, 1999).

<sup>21</sup> As Mosley (1999) notes:

“The assumption of unitary economy, which required to sustain the stock arguments for financial de-repression, is particularly dangerous in Africa. The removal of controls on interest rates and the increase of financial depth do not, on the available evidence, increase the volume of savings or access to credit in rural areas, except by those who already have collateral. This can be readily explained in terms of reluctance of commercial banks to lend to those who lack this attribute, which distorts the market” (p. 381).

## Chapter 6

### From Stabilisation to Adjustment:

### Is the Developmental State the Missing Link?

#### 6.1 Introduction

The central argument in this chapter is that the rationale underpinning IMF programmes has set aside the developmental role of the state, despite conclusive evidence that it has contributed to industrialisation in other parts of the world, not least East Asia. Indeed there is a theoretical, historical and empirical case for state intervention to guide structural transformation. The East Asian developmental states were successful in achieving rapid growth, not least the state mobilising finance and because of state-society relations that allowed for selective credit, subsidies, protection, and other industrial policies. Despite such conclusive evidence, there is no clear strategy on how to go beyond the minimalist state approach. IMF programmes still set aside the developmental role of the state.

Four elements marked the emergence of the neo-liberal ascendancy from the early 1970s. First, it combined ideological supremacy and the financial backing to push through anti-state-led strategies. Second, denial of the East Asian state-driven industrialisation serves as a platform to argue for dis-engaging the state. Third, based on the impossibility for the emergence of the developmental state in SSA, the Washington consensus concocts a case for a minimalist state vis-à-vis stabilisation and adjustment programmes. Fourth, treating state-society relations as an impediment to implementation of IMF programmes and causes for failure, provides a further justification for de-linking the state from active intervention. The first three elements are explicit and abound in the literature. The last one, however, is subtler and is closely related to the impact of IMF programmes. It is through this last point that this thesis contributes by bringing together the other issues that are often addressed separately. The previous chapters showed that IMF stabilisation and adjustment programmes are theoretically challenged and, empirically, their outcome is at best

inconclusive, and at worst skewed to the negative. This chapter argues that the IMF's use of state-society relations as explanation for failure and non-adoption of IMF programmes has a dual purpose. On the one hand, it is used to vindicate failure of IMF programmes. On the other, it adds to the anti-state stance, which began three decades ago.

The concept of the developmental state centres on the role of public institutions in aiding the market to bring about societal progress, mainly industrial transformation (Johnson, 1982). The idea emerged from the experience of Japan, where intervention led to high growth and industrial development. The intervention was possible through a capable, independent and committed bureaucracy that forged productive relationships with especially favoured capitalists. Through such relationships the state was able to grant selective credit, tax incentives, public-private investment partnerships, high government funded research and development, conflict resolution between capital and labour, and simple and quick administrative decisions (Johnson, 1999). Whilst it is important not to over-generalise, the notion of the developmental state has usefully been exported to other East Asian countries, particularly South Korea, Thailand, Taiwan, Singapore and Hong Kong. Nationalism and ideology have been seen as the driving forces behind these developmental states and the catching-up project was executed through systematic mobilisation of industrial finance. Another key factor to the success of these developmental states has been the prevailing international political economy. South Korea and Taiwan were satellite nations of the U.S. and Japan a significant ally during the cold war. East Asian countries transformed into a capitalist economy through a mix of state-led and market-led policies, as the prevailing political exigency and U.S. tolerance allowed them to improvise (Evans, 1987; Amsden, 1989; Woo, 1991; Kim, 1995; Lukauskas, 2002).

The success and even the existence of the developmental states have been questioned by the ascendancy of anti-state development strategies inspired by neo-classical theories in the 1970s (Lal, 1983, 1987a; Srinivasan, 1985; Krueger, 1990). Much later, a comprehensive revision of economic history presented the success of the East Asian economies as a result of market-friendly, neo-liberal policies (World Bank,

1993). The *laissez-faire* paradigm was presented both as an alternative to state-led strategies and as an explanation of previous successes (Krueger, 1974; Balassa, 1981, 1987). Faced with the fact that the Newly Industrialised Countries (NICs) actually had significant state intervention, the neo-liberal explanation resorted to the notion of the authoritarian state as a driving force behind East Asian industrialisation (Lal, 1983, 1993a; Bhagwati, 1986). The message of the *laissez faire-authoritarian* account of East Asian industrialisation is a rejection of the possibility that the state can actually stimulate capital formation and accelerate structural change under a state-corporatist system of “governing the market” (Wade, 1990), complemented by acquisition of technology and infant industry protection (Chang, 1993, 1994; White, 1988; Hoogvelt, 1990).

In relation to SSA, the discourse focused on the possibility of reproducing the developmental states of Asia (Stein, 1995b). The pessimists, referring to poor record of past economic performance, rallied to show what Mkandawire (1998) terms the “impossibility thesis”. According to this, SSA states cannot be developmental because they lack ideology or a national project (Callaghy, 1990), the bureaucracy is weak (World Bank, 1994), state-business relations are based on patrimony and rent-seeking (Bates, 1981, 1988; Pletcher, 1986; Sangmpam, 1992; 1993). The SSA state is seen as personalistic, dictatorial and kleptomaniac (Jackson and Rosberg, 1982; Gray and McPherson, 1999). The impossibility case argues much of the post-colonial strategy focused on anti-capitalist strategies and poor coordination of economy wide institutions and markets (World Bank, 1981; Ndulu and O’Connel, 1999). It is argued that industrialisation strategies over-extended public ownership, over-expanded industry, and over-invested in import-substitution. As a result the private, the agricultural, and the export sectors turned out to be underdeveloped (Meier and Steel, 1987).

By arguing that the developmental state cannot emerge in SSA and attempts to create it are anti-productive, a case is made for stabilisation and adjustment programmes. A further impetus to de-linking the state came from the view that state-society relations are obstructions to successful implementation of IMF programmes. The state’s ideology, weak capacity and interest group pressures are presented as

obstacles to adoption of IMF policies (Callaghy, 1990; Bienen, 1990; Wolgit, 1997). The theoretical and empirical foundations of public choice theories, on which the state-society relations are based, however, fail to explain the possibility that rents can actually be constructive for positive development outcomes (Khan and Jomo, 2000). Indeed, non-adoption, interruption and failure of stabilisation and adjustment programmes are blamed on internal political pressures that delay reforms and exacerbate crisis (Nelson, 1988; 1989b). The case for continuance of policy advice is made on the grounds that policies can be tailored to suit state-society relations through systematic timing and sequencing of stabilisation and adjustment policies (McKinnon, 1973, 1991; Choksi and Papageorgiou, 1986; Edwards, 1992; Haggard and Webb, 1993).

The Washington consensus sets in motion stabilisation and adjustment programmes under a strict conditional regime, justified on the grounds that the IMF is the lender of last resort, and it has to make sure that it will be repaid (IMF, 2001a, 2001b; Khan and Sharma, 2001). Furthermore, conditionalities are justified on the grounds that they are the same as collateral, analogous to commercial bank lending practices (Sachs, 1989a; Mosley, 1991b; 1992b). Most importantly conditionalities signal commitment and credibility to reforms (Rodrik, 1989; Casella and Eichengreen, 1996). The number of IMF conditionalities has been steadily rising in line with increasing involvements of the IMF from its traditional stabilisation area into more elaborate and comprehensive adjustment and structural reforms (Polak, 1991; IMF, 2001b). No matter how many other functions are ascribed, however, IMF conditionalities are designed to alter the behaviour of governments with regard to political structures, social practice, and economic strategy. These conditionalities to the highest degree compromise domestic ownership of policies, because a relationship of financial dependency is established through IMF programmes. The IMF enjoys a bargaining power over the recipient government, mainly through tranching of credit. Therefore, conditionalities, through behavioural modification of the recipient country, establish asymmetrical power relationship based on donorship (Stokke, 1995). Donorship presides over ownership as recipient governments often retract from agreed conditions. By and large, the IMF suspends its programmes as the ultimate manifestation of the asymmetrical power relationship.

Behavioural alteration through conditionalities is driven by the shareholders of the IMF, which are led by the United States (Taylor, 1997). The evidence shows that the nearest members' proximity to the U.S.-led political view, the higher the probability of IMF lending (Barro and Lee, 2001). The adjusting country, on the other hand, possesses specific historical and political institutional conditions in which various interests are represented. The IMF will be paid back the loan it advances whatever the outcome of its policy advice. However, the adjusting countries often face upheaval during implementation of austere policies. IMF programmes, therefore, require a process of galvanising popular support and broad consensus becomes necessary (Drazen, 2001). Conditionalities, therefore, reflect the conflict between the recipient country's objectives and the influence of powerful nations (Killick, 1997). The outcome usually is in favour of the IMF, whose catalytic function and seal of approval give it powerful leverage. For this reason alone, conditional lending erodes ownership of programmes and encumbers their implementation, which is the cause of non-adoption and failure, and not state-society relations, as the Washington consensus would have us believe.

The incompatibility of conditionality and ownership implies that the public usually reacts negatively to IMF programmes and continuance of these in the face of resistance results in transforming the state into a repressive mode. Various studies show that stabilisation and adjustment programmes cause riots, disobedience, and public discontent, which are often followed by imprisonment of journalists, banning of political parties, and detaining of opposition leaders (Franklin, 1997; Ibhawoh, 1999; Stiglitz, 2002). IMF programmes nurture a new form of dependency, one based on neo-liberal policies pushed through by a powerful political hegemony. The dependency is exacerbated by conditionalities; we can call the power structure that merges from conditional finance as a *repressive pseudo-developmental state*.

Such a state consistently set asides the role of the developmental state, forcing a reform agenda, which is often unacceptable and difficult to implement, and forming a state, which has to use repression to implement unpopular policies. In contrast, East Asian developmental states transformed into successful capitalist economies through a

mix of state-led and market-led policies. They achieved this as the prevailing ideology and U.S. tolerance allowed them to introduce “dirigiste” measures. Most of all unconditional lending allowed them to develop home-grown policies and promote key sectors of the economy. The SSA case is not the same since conditional finance has been imposed in the face of scarce external finance and meagre private lending.

There is a clear anti-developmental driving force to the Washington consensus, mainly because obsession with stability of monetary aggregates and removal of market distortions does not address fundamental structural questions (Stein, 1992, 1994; 1995a). Although stabilisation and adjustment programmes include supply-side measures in the form of market liberalisations, they unduly rely on removing distortions in the exchange side. Exchange rate and financial liberalisation may increase availability of foreign exchange and investable finance. However, production requires precisely the introduction of new “distortions” such as research and development, firm-specific knowledge, product differentiation, scale economies, and externalities, based on some form of state intervention (Amsden, 1994, 1997; Chang, 1999). Given the limitations of primary commodity exports, SSA requires some success in industrialisation to augment living standards. It is not sufficient to improve macroeconomic indicators as long as weaknesses in institutions, infrastructure, and available human resources constrain export performance, particularly manufacturing exports.

The impact of neo-liberal policies has been to build the capacity of the state in a paradoxical way. Its strength was needed to carry out the unpopular stabilisation and adjustment policies through capacity building and good governance. But its ability to emulate the developmental states of Asia through mobilising finance, providing incentives and protection has been curtailed. The logical step of moving from nation building to economic development has been cut short. Macroeconomic stability may be achieved through stabilisation and adjustment policies, but developing into a competitive and technologically advanced economy as well as successful transformation of society requires a developmental state. Unfortunately, IMF-sponsored stabilisation and adjustment programmes, constantly impedes the emergence of such a state as the case of Ethiopia and Uganda demonstrate.



The rest of this Chapter is organised as follows. Section 6.2 reviews the theory and experience behind the developmental states of Asia and shows the modalities, which brought about successful industrialisation. Section 6.3 examines the debate over the identification and reproducibility of the Asian developmental states and the neo-liberal explanation for Asian industrialisation that questioned the autonomy, the capacity, and the desirability of the state to alter incentives from the market. This section also outlines the arguments for reasserting the developmental state through various channels, mainly its assistance in acquisition of technology and protection of property rights. Section 6.4 extends the discussion to show how doubting the feasibility of the developmental state in SSA was presented as justification for, and vindication of, the Washington consensus. Section 6.5 will turn to argue that state-society relations, which formed the basis for the “impossibility thesis”, have been used to explain non-adoption and programme interruption, further pronouncing the demise of state-led strategies. Section 6.6, drawing on examples from Ethiopia and Uganda, demonstrates how the state, under IMF programmes, has failed to tackle major structural issues and has not imported the role to be played by the developmental state. Concluding remarks are provided in Section 6.7

## **6.2 The Developmental State**

The literature on the developmental state refers to the industrialisation experience of East Asian economies and entails the political and bureaucratic influences of the state in organising capital accumulation and honing international competitiveness. The notion of the developmental state emerged from the experience of Japan, studied by Johnson (1982), who argued that the state through its Ministry of International and Trade and Industry (MITI), has coordinated and brought about rapid economic growth between 1925 and 1975. Johnson argued that the Japanese economic system was neither based on central planning as in the socialist sense nor on free market where private ownership and control dominate. Instead, the Japanese system was led by a “plan rational” state whose interventions run alongside private ownership. Johnson declared that his intention for drawing attention to the

developmental state is to challenge the conventional divide between U.S. style market capitalism and Soviet style central planning, to point that there is another form of capitalist system: the “capitalist developmental state”. The purpose was to expound on the Japanese developmental state that withstood economic down turns and managed to maintain stable growth while most developed countries fell into recession and stagflation (Johnson, 1999).

The notion of the developmental state is not strictly about whether the state should intervene in the economy or not, but interest is on what kind of intervention leads to high growth and industrialisation. The developmental state, as understood in the literature, is a state that intervenes with the unambiguous objective to industrialise. This contrasts with intervention aimed at shaping procedures and rules to achieve a competitive market-oriented economy, invariably propagated by the Washington consensus. The interventions of the developmental state take various forms. First, there must be a small and capable bureaucracy that identifies the industries to be developed, selecting the method by which such industries develop and creating an environment where firms obey the rules for competition. Second, the bureaucracy is given a political space to operate independently and effectively. Third is use of government institutions to plan and guide production and exchange. These include government financial institutions to grant selective credit, tax incentives, public-private investment partnerships, high government funded research and development, conflict resolution between capital and labour, and simple and quick administrative decisions. Fourth are organisations such as MITI: a democratic and driven institution to design industrial and other subsidiary policies (Johnson, 1982)

Analysis of the Japanese experience has been interpreted as a Weberian historical analysis, which attempted to uncover the motives of Japanese policy makers to adopt the “plan rational” system of production and exchange. The conclusion was that Japan responded to the economic dominance of North America and Europe. The reaction was nationalism and social mobilisation that aspired to elevate Japan to higher economic status. The actions of the developmental state were also spurred by the desire to counter economic depression, prepare for war, invest in post-war reconstruction and graduate from post-war foreign, especially U.S., assistance.

Therefore, the developmental state required a clear “ideology” or a “national project”, which guided social transformation (Johnson, 1982; 1999).

Although the developmental state appeared in a particular time and in a particular setting, according to Johnson (1999) “it is both particular and generalisable.” The interesting aspect of the developmental state idea, therefore, is its export to other countries, particularly South Korea, Thailand Singapore and Hong Kong. Later additions to the developmental state included Indonesia, Malaysia, Sri Lanka, and Thailand. Chile and Turkey are also considered non-Asian developmental states. For South Korea, the Japanese colonial legacy put down certain initial conditions indispensable for capital accumulation, particularly a well-developed agricultural sector. The South Korea state actively embraced the developmental state and its objectives to funnel industrialisation through allocating and mobilizing financial resources (Kohli, 1999). Ideology was not a sufficient condition but required committed policy makers and political leaders. The Japanese, Korean and Taiwanese leaders and policy makers had experienced wars and came out determined to execute the nationalist agenda: economic nationalism (Johnson, 1999; Woo-Cumings, 1999a). A dedicated developmental state as in “Singapore Inc.” has delivered employment, income, homes, education, security and welfare (Huff, 1995; Low, 2001). State interventions in Chile at the sectoral level identified and supported comparative advantage quicker and at lower cost than the market could. Intervention in information provision, credit and input supply as well as insurance against risk worked successfully. The case studies in the Chilean fruit, fish, and forestry sectors, suggests that public interventions were “crucial catalysts in shaping a sustained export response” (Kurtz, 2001, p. 1).

However, nationalism, ideology and other initial conditions can only be executed if the state is also capable of *mobilising the finances* needed to achieve industrial development. The developmental state was successful in directing finance to industrialisation, as advocated, for instance, by Gerschenkron (1962). State allocation of finance in the Asian case was also similar to those observed elsewhere. France has followed the same bank-based credit allocation, as opposed to equity-based system (Loriaux, 1999). The state in Finland also successfully financed

industrialisation through control of interest rates and bank-based credit allocation (Vartiainen, 1999). The developmental state allocated finances through credit-based financial structures and influenced investment patterns and sectoral mobility through control of interest rates. The credit-based financial allocation also allowed firms to obtain funds from the banking sector well above retained earnings (Zysman, 1983). In the case of South Korea the developmental state was able to channel subsidised finance to the *Chaebol* and in the process created a coalition of capitalist interests that rallied behind the ideology of nationalism (Amsden, 1989; Woo, 1991). Interest rates on loans advanced to exporters were subsidised by as much as 75 per cent and direct allocation of credit to priority sectors was normal practice (Kim, 1995). Statistical evidence for Brazil confirms that state coordinated savings substantially influenced economic growth rates (Krieckhaus, 2002).

An important aspect of the developmental state that enables it to synchronise development finance is the *structure of the bureaucracy*. Developmental states need a high degree of internal cohesiveness, supported by a competent bureaucratic entity. The East Asian economies are characterised as developmental states because they possess strong and autonomous bureaucratic leadership that directs the economy toward achieving the national project. The bureaucracy in Japan, despite the country's defeat in WWII, firmly remained in control to guide post-war development (Nakamura, 1981). Comparison of the East Asian and Latin American industrialisation process revealed that the critical variable is the constitution of the bureaucracy. The *Desarrollista* states in Latin America entailed a bureaucracy that is politically tied and appointed, which is also dispensable during regime change. The *Desarrollista's* system of political capitalism allowed the state to determine profits and investment through ideology of exclusion, military control and banning of opposition. Latin America created a bureaucracy that was slower to guide industrialisation (Schneider, 1999). Such "appointive bureaucracy" with a tenuous power base contrasts to the Asian professional and competent bureaucracy that is embedded in the state's national creed. However, a competent and long-standing bureaucracy is not a sufficient condition for the developmental state's success and cross regional comparisons are sometimes misleading.<sup>1</sup> In the case of India's developmental state it has been shown that the bureaucracy, although capable, was not

embedded in the ideology of development. The Indian developmental state failed to unite the fragmented private sector. Instead the state favoured individual capitalists through patronage such as ethnicity, loyalty, birth, and family relations (Herring, 1999). Interagency relations had different outcomes in India and South Korea. While, both countries had vigorous bureaucracies, the Indian bureaucracy was not cohesive compared to its South Korean counterpart (Chibber, 2002).<sup>2</sup>

The developmental state aided by a competent bureaucracy forges a unique *relationship with businesses* to steer the forces of social transformation. For successful financing of industry the relationship must be mutually beneficial. The state identifies and rewards successful businesses. Private capitalists, in turn, respond to the incentives the state institutes. Specifically, the state in Japan's development has been instrumental in cartelising each industry and restricting entry. Such protection of industrial groups (*keiretsu*) took the form of financial and legal assistance to fend off foreign competition (Nakamura, 1983). South Korea used protection to reward exporters and threatened non-exporters with removal. Since protection is granted on the basis of previous success, a snowballing effect was built in the system of incentives leading to the development of the *chaebols*. These big businesses were promoted to a level where they could compete internationally and reap economies of scale as a result of their large production capacity. Other mechanisms included allowing a two tier pricing system which enabled producers to charge a higher price domestically and a lower price in the international market, by providing subsidised interest rate, foreign currency loans and special insurance. At the same time consumer goods imports were restricted under extensive negative list and effective protection rates increased to shield infant industries (Kim, 1995). By 1990 subsidy in Malaysia from protection and non-protection incentives reached 3.7 per cent of gross national income (Edwards, 1995).

Initial conceptions of the developmental state treated it as isolated from *international political economy* and presented the state as an agent that mediates among local interests to pursue a certain national goal. However, the developmental state is dependent on, and sometimes the result of, international interests transmitted through international political influences, foreign capital and overseas export markets.

The international community, most importantly the U.S., tolerated Japanese protection as a source of political gain through post-war alliance and cooperation (Johnson, 1999). South Korea and Taiwan also became satellite nations of the U.S. As a result, these countries were able to advance their own version of capitalism as the Cold War increased the tolerance of the U.S. to alternative capitalist developments, which were based on credit rationing, price controls, investment subsidies and repression of interest rates (Pempel, 1999; Vartiainen, 1999). U.S. aid to South Korea averaged 80 per cent of gross domestic investment between 1953 and 1962 (Evans, 1987; Amsden, 1989). U.S. aid to South Korea in the 1950s and 1960s has also been accompanied by easy access to the U.S. market (Edwards, 1992; Pempel, 1999).<sup>3</sup> The East Asian developmental states used financial controls to mobilise resources for industry, while political and security imperatives put up with the degree of inefficiency introduced into the financial sector (Lukauskas, 2002). Similarly, Austria, Finland and Taiwan have all experienced a drive to development, mainly as a result of security fears and the urge to catch up with the developed economies. Thailand's well-developed network of rural roads was the result of U.S. finance, which was mainly triggered by security concerns. The "political underpinnings" or a nation's political status in international alliances and the global security environment is one of the most important conditions for the success of the developmental state (Mackie, 1988).

In sum, from this wide-ranging and selective account, it can be concluded that the developmental state is far from the central planning and market-fundamentalism models, but close to a systematic contextual intervention to create a competitive industrial base. The importance of industrialisation, particularly the emergence of a dynamic manufacturing export sector is the most crucial in the progress from low to higher income levels, both from historical and structuralist theoretical points of view (Singh, 1982; Hawkins 1986; Chenery *et al.*, 1986; Kitching, 1989).

### 6.3 The Developmental State Contested

The idea of the interventionist later moderated as developmental state ran into opposition in the 1970's, as anti-state development strategies based on the neo-

classical theory rose to ascendancy. State-led strategies have been attacked for being “optimistic” and “completely out of touch with the realities” (Srinivasan, 1985, p. 45). The neo-liberal thinking argued that “market failures” are more tolerable than “government failures” (Krueger, 1990). Government intervention under the Washington consensus has been demonised and liberalisation of markets have been favoured, despite second best theory implied that liberalising more markets, but not all, does not lead to allocative efficiency (Chang, 1993) and imperfect information and concentration of market structure may generate dynamic gains and comparative advantage through reducing uncertainty, innovation and economies of scale (Amsden, 1989, 1997; Chandler, *et al.*, 1997).

The “new political economy” (NPE) gave the neo-liberal camp the justification to depoliticise the economy further, as state involvement and politics are considered corrupting and wasteful as well as distorting. The breakthrough by the NPE was to show that although the quest for self-fulfilment in the competitive market leads to efficient outcomes such self-interest in politics is damaging. The NPE views political groups or agents as rational, forward looking and optimising and presented an “economic theory of politics”. The NPE came up with three critical features - suspicion of the state’s motive in policy making, the prediction that necessary reforms will not, in the presence of interest groups, ever be carried out and the assumption that the actions of national states are independent of global political economy (Lal, 1983).<sup>4</sup> Lal (1987b, pp. 276-277) also states:<sup>5</sup>

“[M]ost of the existing literature on the order of liberalisation is based on the economist’s traditional picture of disembodied, altruistic policy makers maximising some social utility function subject to the usual resource and technological constraints. This view of the state is highly misleading, particularly when one considers the heterogeneous group of countries that comprise the developing world. By contrast, it is more useful to follow the “new political economy” [NPE] and view the State as composed of a group of self-regarding individuals and groups interacting strategically with private agents. The State is then seen as seeking to maximise its own utility (including incomes, perquisites, and power) and not necessarily the welfare of its citizens.”

The advent of the NPE separated the discourse on the developmental state into the “economic school”, which is based on the need for the state in aiding the market to

bring about specific objectives, and the contending “political school”, which questions the autonomy of the state and its capacity to insulate itself from special interests for a broader societal objective (Fine and Stoneman, 1996; Fine and Rustomjee, 1997). At the same time, in a complete re-reading of economic history, the success of the East Asian economies was attributed to market-friendly neo-liberal policies. The World Bank refers to the “Asian Miracle” as “market friendly” approach, where governments ensured increased investment in developing human capital, provided a competitive climate for private enterprises, opened the economy to international trade and maintained a stable macroeconomy (World Bank, 1993). The implication for other countries is, therefore, the reconfirmation of the earlier *laissez-faire* policies and a further retracting from assigning a vital role for the state (Balassa, 1981; Bhagwati 1986; Balassa and Williamson, 1987; Krueger, 1990).

A number of studies, however, showed that neo-classical, neo-liberal readings of the East Asian success are misleading (Wade, 1996; Amsden, 1994; Clark and Kim, 1995b). The World Bank’s export orientation versus import substitutions is a false dichotomy, and states intervened in lowering real wages for labour-intensive industrialisation strategy (Stein, 1994). There was a growing recognition of the importance of externalities in the area of information processing, learning and acquisition of technological capability. In developing countries some of these externalities are internalised in non-market institutions like large corporations. The state in East Asia played a role in promoting the crucial learning processes and offsetting externalities, in addition to its role as substitute for missing capital markets (Datta-Chaudhuri, 1990; Westphal, 1990). The existence of market failures in the form of human capital; information asymmetry; crowding in private investment; industrial policy, are given high status by confirming that non-market institutions are effective in organising economic systems (Chang, 1994). Therefore, as far as the Asian success is concerned there was room for intervention to correct market failures: what is named the “counter-counter revolution” (Krugman, 1992; 1994).

The developmental state model also focused on guiding market economies in which intervention focused on “strategic industries” based on criteria such as global demand elasticity and the potential for technological progress (Chang, 1993). The



Asian success is based on strong state intervention, infant industry protection and temporary shielding of domestic firms from international competition, which emphasises that comparative advantage benefits the dominant economic powers, and late industrialisers will not benefit from unfettered trade (White and Wade, 1988; Hoogvelt, 1990; 2001).<sup>6</sup> There is strong empirical evidence that confirms the South Korean state was instrumental in facilitating the transfer of technology (Amsden, 1989) and the mobilisation and control of finance for industrial policy (Woo, 1991). The evidence also shows Taiwan's distinct non-market and non-plan developmental state took measures including import-substitution, protection of domestic markets and overvalued exchange rates (Wade, 1990; Wu, 1994). Only later did Taiwan adopt an export-oriented strategy after a gradual and cautious liberalisation of key markets. Taiwan's trade until the early 1970s was characterised by a variety of tariff, non-tariff barriers and quantitative restrictions and the nominal exchange rate was tightly controlled (Bräutigam, 1995). Hong Kong and Singapore, although perceived as models of market capitalism, have had mixed economies and used protective measures, possibly less so than Latin America (Hirschman, 1968; Ranis, 1990). The NICs became the epitomes of rapid development because they had a particular geographic position and historical experiences as well as the state's unique mix of inward- and outward-looking policies (Brohman, 1996) and not necessarily because they were authoritarian.

The developmental state has a role to support sustained industrialisation through providing vision, moderating conflicts and establishing the foundation for growth such as education and infrastructure. The critique of the neo-liberal programme highlighted the confusion in neo-classical economists between allocative and dynamic efficiency. The former does not automatically lead to the latter, and there is neither a theoretical rationale nor empirical proof to suggest otherwise (Taylor, 1993a). A free market also depends on time and place. What is regarded a free market today may not have been few years back, or what is regarded a free market in a developed country may not be a free one in a developing country. A free market depends on a society's definition of a system of rights considered legitimate (Chang, 1999). The neo-liberal doctrine also underestimates the possibility that bureaucrats as

well as other interest groups can actually serve the public interest. Lipton (1992, p. 649 emphasis added) notes,

“[I]ndeed, one strand of NPE asserts that there is a strong presumption that State action, ostensibly to improve global outcomes or correct income distributions, will make matters worse, and that State economic action should be largely confined to the provision of clearly public goods. On this view, the state itself is endogenous. Its members and clients, use State power to seek rents...*The use of NPE theorising to justify state compression, and to reject Keynesian and structuralist interventions as incentive incompatible for want of “micro foundations,” is questionable.*”

Faced with the fact that the NICs actually had significant state intervention the neo-liberal explanation resorted to three explanations. First, the theory of “virtual free-trade regime” argued that various measures of state interventions cancelled out one another and produced a neutral market-based incentive structure (Lal, 1983). Second, the theory of “prescriptive state intervention” was advanced, which argued that intervention did not impede growth because it left room for private initiative (Bhagwati, 1988; World Bank, 1993). The third, and more elaborate explanation, argued that the developmental state could only bring about industrialisation and development, when the populace, particularly labour, accepts its ideology, its financing arrangement, its bureaucracy as well as its relations with big businesses. The existence and possibility of galvanising mass support to the national project has been questioned, with forced similarities offered between *authoritarianism* and the developmental state. For Lal (1983, p. 33): “a courageous, ruthless and perhaps undemocratic government is required to ride roughshod over these newly-created special interest groups.” Bhagwati (1986, pp. 100-101) states the “gang of four countries [Hong Kong, Republic of Korea, Singapore, Taiwan] appear to have used authoritarian methods to keep trade union wage demands under control and build on this bases a successful macro policy of low inflation”. By contrast, “pluralistic democracies may find it much harder to dismantle the controls, protection, etc., that inevitably accompany the IS [Import Substituting] strategy. These policy instruments carry patronage and confer on the politicians the power to collect funds for their re-election, so that the economic regime under the IS [Import Substitution] strategy tends to become a critical source of political power” (ibid.).

On a theoretical level the argument for authoritarianism is Olsonian: struggle between “distributional coalitions” results in sub-optimal welfare. Self-interested groups struggle for obtaining a larger share of the national pie rather than enlarge the pie and obtain a larger amount. An individual or group that attempts to benefit society as a whole is providing a public good while bearing the costs of his/its action. A “rational” individual or organisation, therefore, refrains from engaging in activities where the costs are borne individually while the benefits are reaped collectively (Olson, 1965; 1982). Reforms such as subsidy reductions and price decontrols harm urban trade unions and the civil service whose opposition can only be suppressed by an authoritarian government. In a democracy the government is influenced by rent-seeking groups and entertains the wishes of powerful interests rather than carry out radical reforms because it relies on these same groups for political support, votes and finance. “Authoritarian leaders, by contrast, can override interest-group demands by fiat” (Haggard and Webb, 1993, p. 145). Authoritarian and anti-communist states in South Korea and Taiwan insulated themselves from the rural elite and as a result were able to squeeze agriculture to finance industrialisation (Evans, 1987). Authoritarian governments are also able to widen the gap between current production and current consumption (Nehru, 1979).<sup>7</sup> The developmental state must demonstrate its commitment to development through a “process of reputation building”. Credibility and reputation are found to be key determinates to elicit private investment. The “process of reputation building” requires a state free of special interests and authoritarian enough to implement unpopular policies (Dewit *et al.*, 2001).

The *laissez faire-authoritarian* explanation of the “Asian miracle” ignores the systematic role the state played in “supply-push” models for late industrialising economies in the *Pacific Rim* where state promoted capital formation and accelerated structural change (Appelbaum and Henderson, 1992). Johnson (1999, p. 52) comments:

“My position on this controversy is to deny any necessary connection between authoritarianism and the developmental state but to acknowledge that authoritarianism can sometimes inadvertently solve the main political problem of economic development using market forces - namely, how to mobilise the overwhelming majority of the population to work and sacrifice for developmental projects. An authoritarian government can achieve this mobilisation artificially and

temporarily, but it is also likely to misuse such mobilisation, thereby making it harder to achieve in the future. In the true developmental state, on the other hand, the bureaucratic rulers possess a particular kind of legitimacy that allows them to be much more experimental and undoctinaire than in the typical authoritarian regime."

By equating the developmental state with authoritarianism, the *laissez faire-authoritarian school* sends a clear message: even if the Asian success is attributed to state-intervention the trade-offs are democratic values. This position is untenable. In the first instance, there is no conclusive evidence to suggest that both democratic forms of government and authoritarian regimes advance economic development and improve welfare. Although some evidence shows that authoritarian regimes exhibit a larger variance in economic performance than democracies (Sah, 1991), there is no simple distinction between democratic and authoritarian regimes. The distinction is also too stark and rigid (Sorensen, 1991).<sup>8</sup> The NICs neither have been democratic in the sense of meaningful political participation nor were they authoritarian in its brutal sense. Democracies versus authoritarianism discourses are too simplistic and the hypothesis does not also distinguish among successful reformers and not so successful reformers. Although India as a democracy has avoided famine, China had a severe one over 1959-1961. But China also achieved increases in social services in terms of high literacy rates and better health to the poor than India (Sen, 1983). Opposition to reforms may also come from the military and not necessarily from the usual suspects: labour and the urban middle classes (Haggard and Webb, 1993; Bienen, 1990). Gray and McPherson (1999) rightly ask: if we go by the authoritarian state hypothesis, why there has not been economic development in Africa given that 22 leaders have been in power since 1979 and 26 since 1989. According to Rodrik (1996a, p. 19): "there are too many mismanaged dictatorships around the world to take the hypothesis seriously." Alesina and Perotti (1994) also note that inconclusiveness of the literature is due to the heterogeneity of authoritarian regimes: What are we referring to: "kleptocracy"? "authoritarian-corporatist"? or "benevolent dictators"?

Overall the link between authoritarianism and industrial strategy is thin, but a high degree of authority and efficient administration can reform the economy successfully (Toye, 1992). In the Asian cases wage demands have been weakened to compete through labour-intensive exports in the international market. Intervention in agriculture also focused on surplus extraction. The strategy was to increase food

production through investment in agriculture and at the same time to keep rural incomes low, to encourage migration of labour out of rural farming and into urban industries. Investment was in the form of provision of inputs, procurement and pricing, land reform, high levels of public investment in research, and provision of seed variety. In the case of Japan the state was able to use land tax as a form of capital extraction out of agriculture without opposition from the landed class (Nafziger, 1995).

Taiwan's reform, which distributed land to poor farmers dismantled interests working against outflows of capital from agriculture. At the same time rice prices were kept artificially low to keep urban real wages at a minimum. Implicit and explicit taxes have also been used as a form of capital extraction (Brautigam, 1995). The South Korean state, in addition to its direct support to agriculture, as was the case in Japan, deliberately kept grain prices below market levels to encourage the flow of labour into import-intensive manufacturing sector. The migration of labour out of agriculture also kept real wages down. The key to success was a conscious effort to support the farmers without increasing food prices to urban consumers and industrial workers (Kim, 1995). In Singapore real wages were kept low and below productivity through restraining labour union bargaining, directly interfering in settling pay disputes, and most importantly through provision of social goods to obtain the consent of labour (Lim, 1995). These strategies contradict the standard authoritarian/democracy dichotomy of regime types.

The experience of successful industrialisations clearly demonstrates that the developmental state is effective when its leadership resolves collective action problems. What also matters is more egalitarian income distribution, institutionalised networks between public officials, and private capitalists as in Japan and South Korea, and closely tied party alliances as in Taiwan (Bardhan, 1993). The NICs achieved high levels of capital accumulation under a state-corporatist system of political governance, what is dubbed "governing the market". The state created interests with "monopoly of representation" and simultaneously monitored their activities so that there was no "narrow, conflictual demands" (Wade, 1990). What is crucial is also continuity or discontinuity of the regime, rather than its democratic and authoritarian attributes

(Waterbury, 1989, p. 50). The advent of the “post-Washington Consensus” also heralded the death of the need for an authoritarian state. This was evident from a series of papers, which came out in the late 1990s from the World Bank, to demonstrate the possibility of a Comprehensive Development Framework (CDF), which is based on a holistic approach and participatory processes in advancing economic development (Stiglitz, 1999b; 2000a). According to Stiglitz (1999b, p. 2):

“participatory processes (such as “voice”, openness, and transparency) promote truly successful long-term development. This is not to suggest that those that are highly participatory, at least in formal structure, have failed to achieve development success. But it does mean that an understanding of centrality of open, transparent, participatory processes in sustainable development helps us to design policies-strategies and processes-that are more likely to lead to long-term economic growth that reinforce the strengths of the processes themselves”

The evidence shows that the NICs gradually embraced democratic values. This is consistent with the premise that regime types are endogenous to the development process itself. Capitalist development can foster democracy as it transforms the class structure, increases the number of working and middle classes and their organisational capacity, making it difficult to exclude them in the governance structure. In addition, capitalist development dismantles the land owning elite or the feudal system that clings to the non-capitalist mode of production (Rueschemeyer, *et al.*, 1992). It is the emergence of a vocal working class that facilitates the advent of democratic traditions (Haggard, 1990) – a testimony to Marxist view of the role of the bourgeoisie in democratic developments and Moore’s (1966, p. 418) “[N]o bourgeois, no democracy” assertion. More recently, a study of 100 countries from 1960 to 1995 showed that democracy measured by electoral rights is positively associated with improved standards of living (Barro, 1999).<sup>9</sup>

“Inspection of the cross-country data suggests that countries at low levels of economic development typically do not sustain democracy. For example, the political freedoms installed in most of the newly independent African states in the early 1960s did not tend to last... Thus a casual view of the data seems to support the Lipset/Arstotle hypothesis” (ibid. p. 163).

Yet, just as the idea of the developmental state was gaining in prestige the 1997 Asian financial crisis set it back again. Some have even suggested that financial

globalisation in the 1990s “effectively dismantled the Asian developmental state and forced East Asia to search for a new political economy model” (Pang, 2000, p. 570). Financial liberalisation and the consequent capital movements in and out of Asia reduced the dependence of businesses on state directed finance. The expanding financial portfolio of Asian corporations questioned the traditional role of the state, particularly because the crisis was not prevented by state action (Chan *et al.*, 1998). As Fine (2001c) summarises, the discourse on the death or otherwise of the developmental state, centres around three themes.

First, the developmental state is a temporary configuration of state-society relations solely designed for catching up by late industrialisers (Moon, 1999). Second, the developmental state has been superseded by gigantic businesses, which disabled it from correcting institutional weaknesses in the financial sector (Lee, 1997; Kim, 1999). Most notable is state-businesses relationships led to the formation of corrupt state officials and powerful big family-run industries forming an oligopolistic structure, what is called “crony capitalism” (Cummings, 1999). Third, and more convincing, the developmental state is not to blame for the financial crisis as opposed to neo-liberal-inspired rapid financial and capital market liberalisations (Krugman, 1999; Wade, 1998; Chang, 1998, 2000). Financial liberalisation made emerging economies more vulnerable to both currency and banking crises by allowing more liquidity to inflow, which finds its way into speculative projects increasing the chance for borrower default (Weller, 2001; Stiglitz, 2002). In South Korea premature liberalisation that did not take account of weaknesses in institutions, resulting in crisis. Financial liberalisation, where excess liquidity exists and when the real sector cannot absorb it, leads to speculative investment (Demetriades and Fattouh, 1999). The crisis in Thailand was also the result of financial liberalisation in the face of weak institutions (Alba, *et al.*, 1999). Often liberalisation of both the external and internal markets results in financial flows both to the productive and speculative sectors. However, the mismatch between the slow growths of the real sector compared to the financial sector diverts capital to the speculative sector, which in turn results in banking and currency crisis (Weller, 2001).

The Asian financial crisis offers lessons to be learned by the developmental state and not a harbinger for its demise. The presumed death of the developmental state should not detract the role it played in history, especially given the weakness of the market-led alternative strategy. The point is that the successful Asian developmental states created an industrial base, which transformed them into export-oriented, competitive and high-income economies. As Stiglitz (2002, pp. 91-92, emphasis added) put it:

“Whether one calls it a miracle or not is beside the point: the increases in incomes and the reductions in poverty in East Asia over the last three decades have been unprecedented. No one visiting these countries can fail to marvel at the developmental transformation, the changes not only in the economy but also in society, reflected in every statistics imaginable. Thirty years ago, thousands of backbreaking rickshaws were pulled for a pittance; today, they are only a tourist attraction, a photo opportunity for the camera-snapping tourists flocking to the region. *The combination of high savings rates, government investment in education, and state-directed industrial policy all served to make the region an economic powerhouse.*”

A role for the state has been given theoretical backing from various quarters. Markets are considered as transactions by institutions faced by imperfect and costly information, which increase transaction costs (Stiglitz and Weiss, 1981; Stiglitz, 1989). Under these conditions Pareto-efficiency may not be achieved (Akerlof, 1984). Therefore, institutions are important for markets to function, and institutional structures must be developed to counter the agency problems associated with moral hazard and adverse selection, particularly in the financial sector. Based on this approach, the “post-Washington Consensus”, which emerged towards the end of the 1990s, resurrected market failures and argues that we are living in a world where there exists imperfect information, hence government intervention, “while itself bound by some informational limitations, can make at least some people better off while not making anyone worse off” (Stiglitz, 1998c, p. 1).<sup>10</sup>

The continuous search for new roles for the state is commendable. Nonetheless, inclusion of market imperfections presumes a logical progression from microeconomic equilibrium to better developmental outcomes. The debate needs to move away from the state’s complete absence or full play to its developmental role. All states intervene and the focus should be on the quality as well as the quantity of



intervention. Failure of the state can be explained by rent-seeking just as success in industrialisation can be explained by state intervention. As prominent writers in this field argue there is a need for “reconstruction of the developmental state” (Chang, 1999). Such reconstructions need to focus on: 1) the role of the state in coordination for change, provision of vision, institution building and conflict management (Chang, 1999); and 2) the production side of the economy, moving away from the exchange rate, and trade and financial liberalisation as the sole determinants of development (Amsden, 1997).

First, the role of *coordination for change* is needed to assure the extension of complementary investments and reduce the cost of adopting new technology by firms. As technology is embedded in the capital stock, under fragmented ownership, the transaction costs of formulating and monitoring contracts among a large number of agents is likely to be high. Second, the developmental state can *provide the vision* for moving from low- to high-equilibrium or from moving to a given choice set to creating additional choice sets. In a world of static efficiency the state can change relative prices and achieve a movement from one equilibrium state to another. However, static efficiency does not necessarily imply institutional and structural transformation (Nissanke and Stein, 1999; Stein, 2000). Thus the state, like an entrepreneur, sets goals and provides vision to achieve them. Third, the *institutional building* role of the state is necessary to guarantee the realisation of the developmental “vision”. Such functions come from the need for minimising transaction costs, guarantee property rights, invest in research and development, and resolve the uncertainties in the market economy along the lines advocated by Coase (1992) and Williamson (1995). Fourth, *conflict management* is a key role that the developmental state can play. The conflict arises when the economy moves from low- to high-productivity production, specifically from agriculture to manufacturing. The shift, under imperfect factor mobility, creates losers in terms of lost income and employment. This manifests itself when agents find it difficult and resist shifting assets, skills, contracts and even patronage from one sector to another. The state supports losers and winners through increased investment and socialisation of risk (Chang, 1999).<sup>11</sup>

Theoretically, IMF stabilisation and adjustment programmes focus too much on the exchange side of the economy. Exchange rate liberalisation may remove major bottlenecks, trade liberalisation may open up new markets, financial liberalisation may increase availability of finance, and privatisation and FDI may introduce new technology. However, these are all based on the assumption that there exist production sectors waiting to reap the benefits of liberalisation. This is a spurious position and concocted to disengage the state further. Liberalisation attempts have generally not been adequately tailored to address the specific problem of product development in the context of industrialisation. The least developed countries, do not have manufacturing or agricultural sectors with brand-name, technology, and know-how to benefit from liberalisation without state guidance in diffusing technology and providing the necessary incentives. As Amsden (1997) puts it:

“...despite the craze for liberalism in the 1990s, the elite of development economists at present neglects production almost entirely in analysing the state’s role in industrial development. Microeconomic questions about how firms are formed, how technologies are acquired, how industries emerge, develop or die, and what role governments play in the process occupy an infinitesimally small place compared with macroeconomic questions about fiscal prudence and foreign trade” (p. 469).

The chasm between the developmental state and the IMF’s view of development is mainly that the latter’s thinking lectures the merits of unfettered markets and recommends de-regulation, liberalisation, and privatisation. In other words it is anti-interventionist. The argument for a minimal, pro-business state has been further strengthened with both the increase in the involvement of the IMF in developing countries and the rise of neo-liberalism and globalisation.

As discussed in Chapters 2 and 3, the IMF, fundamentally believes in the neo-liberal resurgence that changed the terms of debate on the role of the state. Contrary to its developmental role, the state is no more assumed to be a neutral guardian of public interest. The IMF prescribes to the notion that the state is a “predator” or a vehicle for politically powerful groups and their interest, for instance as in the case of rent-seeking discussed in Chapter 3. The IMF’s policy advocacy is based on the assumption that the state has no other motive other than maximisation of material

self-interests. This position, unlike the developmental state, effectively cuts out the role of politics as a valid way to correct the market outcomes according to the “collective will” (see Chang, 2003).

Although the IMF’s view of development is anti-technocratic, in the sense that it opposes the idea that the state can correct market failure, it accepts rectification of such failures in “politically acceptable” areas, for example in infrastructure development and policy design. This contrasts with the rejection of successful industrial policy of the kind seen in East Asia (Evans, 1995a). This dilemma arises from the theoretical underpinnings of the IMF’s view. First, mistrust of the state is entrenched in the view of development to which the IMF subscribes. State involvement and its bureaucracy are in effect considered corrupting and wasteful because they always work for their own interest. This view places trust in the rational and forward looking individual entrepreneur. However, this is a contradictory position. On the one hand, the state is trusted in certain areas including setting rules and regulations, enforcing contracts, infrastructure development, and maintaining security. In these areas the autonomy of the state and its ability to protect itself from special interests for a broader common objective is accepted, while not in promoting industrial policy. In addition, trust of the individual entrepreneur assumes development and entrepreneurial activity as solely individual efforts. This view neglects the fact that knowledge is dispersed and entrepreneurial activities essentially result from collective effort, not least state interventions that generate incentives (Burlamaqui, *et al.*, 1997).

Second, the IMF subscribe to the view that focuses on the principal-agent framework. This framework highlights the difficulties associated with monitoring by the principal. This is related to the difficulty of designing incentives for agents who are condemned to pursue their own self-interest. One example is the problem linked to designing industrial subsidy schemes and the difficulty of pinpointing where and how problems arise. These could be external shocks or bad management, but may not be obvious to the principal or in this case the state. However, state intervention should not be rejected on the grounds of a principal-agent framework, where identifying the principal and the agent is problematic. As Chang (2003, p. 32-33) put it:

The political process in a modern society involves collective action and bargaining problems at different levels (local, industry, or national levels), whose solutions are strongly influenced by social norms (working class solidarity, work ethic, abstinence) political institutions (dictatorial, corporatist, nationalism, welfare statism, free enterprise). The principal-agent model, given its sole emphasis on wealth-maximising behaviour or selfish individuals, cannot take such complexity of political-economic process into account. Thus seen, there are serious dangers in accepting the radical proposals for rolling back the state derived from such models.

The IMF's view of development, based on the neo-liberal schema, exposes its own inconsistencies. It fails to provide clear-cut criterion to draw the boundary between positive and negative state interventions. One conclusion that can be made from this observation is that despite its facade of logical consistency and straightforward divisions between various interventions, the IMF's view of development is based on a fundamentally contradictory intellectual dogma.

As discussed earlier, the state in East Asian economies assisted the private sector in building a modern and competitive production base and its progression from labour-intensive to large capital-intensive stage. The IMF's view of development equates correcting market failures in exchange with correcting market failures in production. Production requires "getting prices wrong" and a deliberate formation of "distortions" to expand investment in productive capacity in the realm of firm-specific knowledge, differentiated products, patents, scale economies, externalities, research and development (Amsden, 1997). The same is true for agriculture. For the least developed countries of SSA, new agricultural technology spurred by research and development is found to be one of the significant inputs (Sanders *et al.*, 1990). Agriculture can also be the "leading sector", and policy can induce rural household demand and facilitate backward linkages through agricultural development (Vogel, 1994). Increased agricultural productivity via technological diffusion and higher rural income produces additional rural household consumer demand and increased food supply for fostering industrialisation, which goes "beyond export-led industrialisation" (Adelman, 1984).<sup>12</sup>

The “take-home message” for the possibility of replicating the Asian developmental state is clear. The issue is not exact cloning of the East Asian experiences but learning, as other countries did, the role the state can play in organising capitalist development.<sup>13</sup> Johnson (1999, p. 40) noted that the Japanese developmental state “would be hard to emulate. If nothing more, it depended to a large extent on losing a big war to the right people at the right time”. The bureaucracy has been built through arduous processes that consumed time and money. However, the East Asian experiences show that the developmental state is not only a result of “economic culture”, such as Confucianism which promotes familial obligations and trust for establishing trading networks (Clegg *et al.*, 1990 and Redding and Tam, 1995), but it is borne out of specific institutional arrangements among states, domestic classes and international interests. Numerous countries adopted the developmental state and improvised to suit their needs. To conclude: the developmental state is possible and its harmful effects can be lessened. However, SSA countries have been singled out as economies where the developmental state could not emerge, which the rationale for de-linking the state and was taken up by the IMF (and the World Bank) as the main strategy for SSA development under stabilisation and adjustment programmes.

#### **6.4 Can the African State be Developmental?**

The major challenges in application of the developmental state of Asia to Africa have been the problems of identification and reproducibility (Stein, 1995b). Identification focuses on pinpointing the factors responsible for industrial development in Asia. Reproducibility refers to the feasibility of replicating the Asian model, with debate focusing on what Mkandawire (1998) calls the “impossibility thesis”. This argues that SSA states cannot be developmental because they lack ideology (a national project), the bureaucracy is weak, and state-business relations mean interest groups easily capture governments (Callaghy, 1993). These factors, combined with poor record of past economic performance in the 1970s and 1980s, call

for a further disengagement of the state and provides an *entry-strategy* for the Washington consensus.

State-led strategies were abrogated as the economic crisis manifested itself in low per capita income, large resource gaps, internal and external imbalances, low level of investment, price instability, and large curb markets (Ndulu, 1993). The African state is blamed for economic crisis, backwardness, weaknesses and largesse as well as its inefficient intervention where much of the post-colonial strategy focused on anti-capitalist and poor coordination of economy wide institutions and markets (World Bank, 1981). According to the narrative, governments in SSA, by abandoning outward looking strategies as colonial, became obstacles to the proper functioning of markets and impediment to social development (Chazan, 1988; Rothchild, 1994). Post-independence governments used fiscal policies and foreign aid to pursue state-led industrialisation, which relegated peasant agriculture to the technologically backward state and crowded-out the private sector (Ndulu and O'Connell, 1999). The most prominent criticism came from a World Bank sponsored publication, Meier and Steel (1987), which pointed out that industrialisation strategies in SSA were based on over-extension of public ownership, over-expansion of industry and over-investment in import-substitution at the expense of private ownership, development of agriculture, and export orientation.

Vilification of the state in SSA is backed up by the ideological ascendancy of neo-liberalism in the major developed countries. Neo-liberalism, both as a result of intellectual developments in the early 1970s and the political victory of the republican-conservative parties in the U.S. and the U.K. towards the end of the decade, was provided as an alternative to interventionist measures, mainly Keynesianism and modernisation. Although, the poor economic performance of the SSA in the 1980s prompted the World Bank to rethink its anti-statist stance, its reports published a decade later, instead of assigning the state a role for mobilisation of resources and financing structural transformation, emphasised "capacity building and good governance" in the form of reforming the judicial system and improving public accountability and transparency (World Bank, 1989a; 1992). The case for the developmental state, particularly for industrial policy was reduced to institutional

reform and regulation of markets. Another report released in 1994 reiterated the need for market-oriented development strategy (World Bank, 1994). As Mkandawire (1998), succinctly put it, the Washington consensus declared:

“African states cannot correct them [market failures] in ways that do not make things worse. What emerges in the literature on Africa is that what has obviously worked in other “late industrialisers” is simply a non-starter in Africa... While it is now admitted that the state has played a central role in the development of Asian countries, it is suggested that replication of the Asian experience is somehow impossible for Africa.”

The economic crisis of the 1970s and 1980s, by implying the impossibility of the developmental state emerging in SSA, killed the rationale for state intervention and led to the pessimism, which was to dominate the subsequent years. The absence of a state with a developmental vision as well as powerful interests and rent-seeking were given as reasons why the developmental state is infeasible in SSA. Combined with the misreading of the Asian success, the ascendancy of neo-liberal thinking meant that the state in SSA was further disengaged.

#### **6.4.1 Is a State with a Developmental Vision Absent in SSA?**

At the heart of the “impossibility thesis” is that the state as well as the domestic bourgeoisie in SSA lack ideology that guides them towards the goal of achieving high rates of accumulation, industrialisation and structural change. As Mkandawire (1998) put it, advocates of the thesis argue that states in SSA lacked the “ideological hegemony in Gramscian sense”, as in Fanon’s (1966; 1967) portrayal of the African ruling classes’ weakness in adopting a developmental ideology. SSA countries adopted an ideology, which is not motivated by religious, socialist, or nationalist attributes to accumulate capital and extract surplus as was the case in Britain, Russia, Germany, Japan and the NICs during their period of industrialisation.

The “Great Man Theory” takes the view that Africa’s predicament is the result of having no “visionary” leaders”. Accordingly, “it is when a leader draws rents exceeding a reasonable estimate of the opportunity cost of his/her time and effort that

the title “visionary” becomes inappropriate” (Gray and McPherson, 1999, p. 21). Reputation of a leader as honest and trustworthy does not necessarily guarantee a corruption free administration. Nyerere, for instance, is portrayed as a leader who disguised rent-seeking under a statist ideology. A visionary leader is one that identifies constraints and designs an appropriate policy to promote agricultural development and manufacturing for exports. According to Gray and McPherson (1999) strong leaders with “vision” hardly:

“merge like Venus from the sea... All leaders, from “visionary” types down to the most venal kleptocrats, are products of social structures, i.e. organisations and networks...as economists we challenge our social science colleagues—sociologists, anthropologists, political scientists—to help answer this question, where Africa can get its leaders? (p. 23)...a case can be made for awarding the title of “most visionary leader of all” to one who believes traditional public foreign aid has impeded his/her country’s development by creating a dependency relationship detrimental to adoption of pro-growth policies, as well as a mobilisation of domestic talent and resources. Such leader will be more inclined to devise an aid/debt “exit” strategy than to persuade donors to augment the aid flow. He/she will be more interested in foreign direct investment than official development assistance” (p. 26).

Equally, the domestic bourgeoisie is accused of being self-interested and domestic debates on development policy are often confined to a small group where mass illiteracy is the norm (Onimode, 1988; 1991). For instance, the bourgeoisie in Sierra Leone instead of transforming itself into a “hegemonic class of capital” was involved in the “construction of kleptocracy, fuelled by patron-clientism”, an “oligarchy, with specific project of creating a unity between the governing and the ruling classes” (Zack-Williams, 1990, p. 22).<sup>14</sup> The ideology that existed was used for regime survival under the guise of post-colonial nation building and the recent democratisation process modernises impoverishment rather than bringing about development based on structural change (Ake, 1996). Ideology has also masked the individual character of dictatorial regimes, which is dominated by rent-seeking groups and lacks the institutional capacity to provoke methodical accumulation (Sandbrook, 1986). The post-independence government of Ghana, Nigeria, Uganda, Senegal and Zimbabwe turned into one party, authoritarian, and personal regimes. The colonial legacy left an example of authoritarian and statist culture, ethnic divisions led to rivalries, there is lack of political culture, and civil society tolerates illegitimate



regimes and authoritarianism (Diamond *et al.*, 1988). *Personal Rule* typifies the African states, which is “inherently authoritarian” (Jackson and Rosberg, 1982).

“an arbitrary and usually a personal government that uses law and the coercive instruments of the state to expedite its own purposes of monopolising power and denies the political rights and opportunities of all other groups to compete for that power.... Modern African authoritarianism is characterised by the removal of constitutional rights and protections from political opponents, the elimination of institutional checks and balances, and the centralisation and concentration of state power in presidential offices, as well as the termination of open party politics and the regulation and confinement of political participation—usually within the framework of a single ruling party” (ibid. p. 23-24).

The literature is rife with commentary that states although governments in SSA professed rapid socio-economic development strategies as their main goal, economic policy was designed for regime survival through buying political support. The policy choice process is explained under the “autocrat” who is the sole policy maker, the “prince” who has the power to overrule, the “prophet” who empowers the bureaucracy, and in the case of the “tyrant” policy is at best unstable and at worst unpredictable. In contrast, in the constitutional multiparty democracy that is said to prevail in Botswana, policy decision is the outcome of harmonious relationships between legitimate politicians and independent bureaucracy (Gulhati, 1990, p. 1152).<sup>15</sup> Post-independence African states have emerged as large and clientelist networks through management of parastatals, taxes and subsidies and transformed into “highly personalistic authoritarian, but weak, administrative states—lame Leviathans—in which crony statism and subordinate crony capitalism prevailed” (Callaghy, 1990, p. 258). This “syndrome” among other things led to surplus extraction from agriculture and inefficient investment decisions based on political rather than economic analysis. Callaghy (1990, p. 318 emphasis added) concludes:

“[M]ost of Africa is neither effectively capitalist, nor even statist. Socialist and statist efforts have come to very little; modern capitalism hardly exists.... for Africa both sides are right: as the structuralists maintain, economic and social structure obstacles to development, internal and external, are enormous; and, as the adherents of neoorthodoxy maintain, *the state is also an obstacle.*”

To begin with the argument that nationalism, state patrimony and rent-seeking are motives for state intervention and specifically for management of public enterprises is a gross exaggeration in the context of SSA. Governments in Africa became managers of public enterprises mainly due to the absence of local bourgeoisie (Mkandawire, 1994b). The post-colonial states were developmentalist and their ideology was nation building, which focused on planning and commitment to eradicate poverty, ignorance, disease as well as provision of social services, infrastructure, and industrial development. The evidence shows that the post-colonial interventions were characterised by high levels of growth, savings and investment rates (Mkandawire, 1999). The developmental state existed and brought about industrialisation financed by domestic savings and high growth successes. In the early 1960s to the early 1970s, Côte d'Ivoire, Kenya, Malawi and Tanzania, pursued developmental policies and achieved accumulation of human capital, extension of infrastructure, and some industrialisation (Stein, 1995c). Both the case studies in this thesis show that rapid growth and high savings were characteristics of the post-colonial period in Uganda and modernisation in Ethiopia in the 1960s.

African states were committed to inward-looking development strategies not because they were against outward-looking strategies. Similarly, earlier strategies focused on land-intensive production not because the state was against labour-intensive policies. Rather, the development strategy focused on earning foreign exchange for industrialisation through export of primary products, and aimed at a gradual diversification of exports.<sup>16</sup> It is precisely the instability of primary commodity exports that locked the strategy and perpetuated the concentration of exports (Sarkar, 1992). The debt burden is also one of the key causes of economic crisis in the region (UNECA, 1989). The findings indicate that external factors contributed to economic decline in SSA, without excluding some important internal factors (see Parfitt, 1990; Mosley and Weeks, 1993). Similarly, states in Africa invited foreign investors as part of the "industrialisation-by-invitation" strategy. The conditions demanded by investors were that the state should introduce protection such as tariffs and quotas. International capital has often demanded and received measures that have "distorted" the market, removing them would hardly have been an attraction

(Stein, 1992). Therefore, the state entered into joint ventures and developed its own enterprises under protection (UNECA, 1989; Mkandawire, 1998).

Individual country experiences also point to the developmental features of African states. The state in Botswana played a significant role in the country's capital accumulation. The state provided direct credit and extension services to local businessmen and farmers as well as subsidies to small-, medium- and large-scale manufacturing (Tsie, 1996b). The state has been effective in guiding industrial policy through a system of financial disbursements to the private sector including support to private manufacturing enterprises, agriculture and mineral processing. The objective was to increase employment, particularly of unskilled labour, increase production both for exports and import-substitutes, and correct income distribution through regional policy. Owusu and Samatar (1997, p. 23) note that:<sup>17</sup>

"Botswana defied the thrust of the prevailing development orthodoxy, which claims that African states cannot enhance industrial development through interventionist strategy. Botswana's state-governed industrial strategy supports recent research on the East Asian miracle, which underscores the fundamental importance of state intervention in industrial transformation."

The success of Zimbabwe in the 1970s is attributed to direct state protection of non-traditional manufacturing (Riddell, 1994). Cross-ethnic and class coalitions, an independent and capable bureaucracy favoured local capital accumulation through public-private partnership, which dominated the post-independence state in Mauritius. The main strategy was to expand sugar production and export to fund public-work programmes through taxation and foreign exchange earnings. A bureaucracy that was capable of identifying market opportunities carried out this strategy successfully up to the end of the 1970s (Meisenhelder, 1997). Drawing from experiences of Ethiopia, and Togo, Manor (1991) showed that the state can engage in various roles simultaneously, beyond maintaining its own interest; the state can be neutral, arbiter, guardian, and developmental.

Another attack on the African state pointed at the lack of institutional, technical, and administrative capacity to correct market failures as well as the bureaucracy's motivation.<sup>18</sup> The rational actor model is ascribed to African

bureaucracies. Due to the intricacy of perfectly rational choice and its costs in terms of time and attention, bureaucrats do not always try to attain optimal solutions to problems. They opt to find ones that fulfil their basic criteria or ones that meet satisfactory standards (Grindle and Thomas, 1991). One example is that self-interested and “foreign exchange maximising bureaucrats” choose capital-intensive technology led by their “expansionist drive” in the public sector (James, 1996). The bureaucracy is weakened as the most competent and experienced personnel left their public posts, mainly as a result of retrenchments, retirement and moving into the better paying private sector (Dia, 1993). The proliferation of capacity building and technical assistance projects in the 1990s is a direct result of the view that institutions of governance are weak, particularly the capacity of its personnel and lack of transparency and accountability (World Bank, 1994 and 2000b). These projects are part of donor conditionalities imposed specifically to carry out neo-liberal policies (Tsie, 1996a). Once again a case is made for rooting out the state and replacing it with market-led strategies at the same time strengthening its capacity precisely for implementing the same strategy. The obvious conclusion is to advocate a minimalist state and open the door for the Washington consensus.

#### **6.4.2 Do Powerful Interests Get in the Way of the Developmental State?**

The weakness of the state in the sense that interest groups influence its decisions is put forward as one of the reasons why the state in Africa cannot be developmental. The policy choice approach is used as a starting point to illustrate state sponsored policy reform processes under the presence of interest groups. The public choice approach draws on the work of Olson (1965 and 1982), Buchanan, Tollison and Tullock (1980), Colander (1984), and Grindle and Thomas (1991). The argument in this approach is the analysis of “distributional coalitions”. Society, in this view, is composed of interest groups each concerned with maximising its own benefit in terms mainly of income and power.<sup>19</sup> The underlying assumption of the public choice model is the division of society into losers and gainers from a particular policy change. Common divisions are between consumers and producers, tradable and nontradable sectors, urban and rural sectors, state and market, and government and civil society.

For instance, business groups favour protection of trade and cuts in taxes, the urban sector presses for subsidised food, the rural sector for increased earnings, the civil service for public sector expansion etc. Therefore, policy change is an outcome of the most powerful group influencing or bargaining with government decisions. Governments in turn are concerned about losing or gaining votes and political support. Once a government is firmly clinging to power and serving its own or the interests of other groups, policy changes are hard to come by. Working against its own and other interest groups are considered irrational. In Olson's line of thinking policy change can only come about if the existing structure of "distributional coalitions" is dismantled due to war, revolution or coup d'état. If not, an economy continues to deteriorate until its demise.

At the centre of public choice theory is the assumption of a dependent or fettered state: a state that is incapable of independent policy making. The theoretical tool is supplied by Olson (1982) who infers "[O]n balance, special interest organisations and collusions reduce efficiency and aggregate income in the societies in which they operate and make political life more divisive" (p. 47). To Rodríguez and Rodrik (1991, p. 1146):

"The answer usually relies on what may be called a "nonneutrality" in the way that the gains and losses from the reform are distributed within society: the gainers from the status quo are taken to be politically "strong" and the losers to be politically "weak", thereby preventing the adoption of reform. (Nondistorting transfers would of course short-circuit this problem, but they are usually ruled out as unavailable). In pressure-group models, this nonneutrality typically expresses itself in the form of differential organizational ability: for example, the gains from the status quo may be concentrated on a small number of individuals while the losses are diffused, such that free riding hampers the lobbying effort of the second group to a much greater extent. In voting models, the nonneutrality operates through distributional consequences across individuals, so that the median voter may prefer the status quo to a reform that would increase aggregate real income."

One example of interest groups, particularly in SSA, is that which identifies them in the urban setting. Early analyses of interest groups focused on the rural-urban resource flows: *urban bias* in developing countries (Lipton, 1976) and anti-rural agricultural policies (Bates, 1981; 1993).<sup>20</sup> The urban coalitions are said to consist of intertwined urban elites consisting mainly businessmen, politicians, bureaucrats,

trade-union leaders, professionals, academics and intellectuals (Lipton, 1982). The central tenet of the argument on “pro-urban” and “anti-rural” is based on the logic of numbers. Since the majority in a typical agrarian economy are farmers, policies that disadvantage the rural sector must be wrong. This line of reasoning is well captured by the following quotes.

“There is nothing wicked or conspiratorial about this. It is the natural play of self-interest and power, only obfuscated by moralising from outside—*cosi fan tutti*, moralisers as well. And it is only one of many ways in which the city (where most government is) screws the village (where most people are) in poor countries. In tax incidence, in investment allocation, in the provision of incentive, in education and research: everywhere it is government by the city, from the city, for the city” (Lipton, 1976, p. 68).

“[G]overnments face a dilemma: urban unrest, which they cannot successfully eradicate through co-optation or repression, poses a serious challenge to their interests as employers and sponsors of industry. Their response has been to try to appease urban interests not by offering higher wages but by advocating policies aimed at reducing the cost of living, and in particular the cost of food. Agricultural policy thus becomes a by-product of political relations between governments and their urban constituents” (Bates, 1981, p. 33).

The urban bias hypothesis is still alive, the clear water between urban and rural passionately idealised. The standard coalition structure in SSA promotes import-substituting industrialisation while redistributing income from rural to urban populations and from poorer to richer income strata. Such a coalition also benefits from the support of intelligentsia due to its populist and nationalist rhetoric (Waterbury, 1989). Frequently cited examples of the above phenomena are agricultural pricing policies. Repression of agricultural prices below market prices is a policy designed to benefit urban coalitions who are more articulate and mobilised. The consequence of this type of policy is to lead the rural sector into subsistence farming, smuggling and “withdrawal” from production of the output whose price is controlled (see Bates, 1981, 1988 and Pletcher, 1986). The state cultivates local support through favoured tax and subsidy systems. The conflict between the objectives of marketing boards and political pressures coming from “labour, industry, and government” works to the disadvantage of farmers (Bates, 1988, p. 357).

The state breeds inefficiencies, distortions and spreads non-Pareto outcomes in return for rents. Anti-rural policies lead to chronic budget deficits that can only be financed by domestic or external borrowing and inflation tax. If further attempt is made to control prices the crisis deepens as the tax base falls, transfers decline and the regimes political base diminishes. Unless reforms that alter the existing system of transfer and entitlement are in place, liberalisation and foreign capital are not much of a solution. The more the government intervenes in the economy the less control it has. Government intervention can be represented by some version of a “Laffer curve” (Lal, 1987b). Government policy that favours a particular interest group does so at the expense of another, diminishing its key developmental objectives. The argument follows that import-substituting policies and food subsidies, for instance, by creating special interests, lead to a “vicious circle” of crisis, whereas export-promoting strategies shift the political equilibrium towards new market-friendly interests resulting in a “virtuous circle” of economic progress (Krueger, 1993b).

The public choice view purports that economic development is sacrificed for short-term political gains. The primordial, patrimonial and paternalistic features of the African state have weakened its developmental capability (Adam and O'Connell, 1999). Similarly, the non-autonomous and clientelist states are unable to establish the state-corporate relationships witnessed in East Asia. Entrepreneurs are not sure of returns, as risk is not socialised and the state is interested in the “politics of the belly” (Bayart, 1993). A developmental state that is capable of being autonomous from interests and strong enough to push forward its mission, as seen in East Asia, is compared to the states of SSA that are deficient in the ideology and freedom to pursue their own developmental project. The notion of the “soft state”, applied in the context of Asia now forms a standard analysis for SSA states (Myrdal, 1968). A critique of the statist models in Africa argued the state is “neither soft nor dead”, but “alive and well” and anti-developmental (Sangmpam 1993).

However, rent and interest coalitions are not necessarily anti-developmental. There is now evidence for a “benign view” of interest groups as not divisive and obstructive, but beneficial (Bräutigam, 2000). The new view of interest groups draws its conceptualisation from theories of pluralism and shows that interest groups can

promote industrialisation. The framework, which mostly alludes to the experience of East Asia, is based on two premises: 1) even though a government is not willing to introduce policy reforms, organised interest groups, which face unfavourable economic environment can demand policy change; and 2) if a reform is already underway, interest groups can also shape and negotiate change.<sup>21</sup> The public and rational choice schools, on the other hand, fall short of explaining whether the predatory and rent-seeking state is a temporary or permanent phenomenon. Killick (1976), in discussing development planning, pointed out the limitations of the rational actor approach: "the use of development planning models--and the elegance and internal consistency they offer--has surely harmed the cause of planning by contributing to a neglect of political realities and the mundane specifics of every day policy" (p. 79). The rent-seeking behaviour - a very important critical tool for the NPE advocates - does not necessarily hinder autonomous state action and impede efficiency of public policy (Skocpol, 1985; Lewis, 1994).<sup>22</sup> In the case of East Asia, state autonomy and its ability in promoting import-substituting industrialisation have been successful (Grabowski, 1994; Leftwich, 1995). Labelling state actions as merely rent-seeking, corrupt and promotion of self-interest does not explain the success of industrial countries that pioneered the system of taxation, minimum wage legislation, and the welfare state (Toye, 1991; 1993).<sup>23</sup>

Weak state-society relations in Africa are exactly reflections of the stage of development, which may disappear with progress over time. As discussed earlier, this point has been used to explain the 1997 Asian financial crisis, that the developmental states had to mature before interests were able to capture them. To argue African societies are inherently patrimonial and clientelist, at their early strategies of development, is at best prejudiced (Mkandawire, 1994a; 1998). Often, rents are accepted if they are meant for export-promotion. However, rents created for import-substitution are vilified. This implies inconsistency in the treatment of rents and rent-seeking. The African state-business relations are considered detrimental, but the same relations in Asia are known as developmental states. Moreover, rent-seeking and patrimony are not altogether harmful, as "embedded" state-private sector relations are possible (Evans, 1995a). Similarly, the Asian experience shows that the state reduced rent-seeking costs and rents were provided on a selective and temporary basis and



withdrawn once industries matured sufficiently to compete internationally and rent realisation was linked to explicit performance standards (Akyuz, 1996).

The key argument forwarded by the authors in the Khan and Jomo (2000b) collection is that rents could be “value-enhancing”. This is related to rents created to tackle market failures and externalities such as asymmetric information, innovations and natural resource conservation. The finding is that conventional thinking focused on input costs rather than rent-outcomes.

“The net effect of the rent-seeking process will depend not only on the rent-seeking costs but also on the efficiency and growth implications of the rents which are created and maintained through this process” (Kahn and Jomo, 2000a, p. 13).

Comparing successful Asian economies with other developing countries, which are not that successful, although both had rent-seeking entrenched in the system, they found that rent-seeking depends on institutional and political variables. Institutional changes, which are key to the development process, involve creating or destroying rents and the outcome may not be unfavourable (Khan and Jomo, 2000a). For instance, rent-seeking costs in Thailand were found to be high and outweighed by benefits. The clientelist structure itself is competitive, which meant that patrons within the state could not protect rents for their clients. Other patrons could create their own clients and facilitate entry in the market (Donor and Ramsay, 2000). In the Thai textile industry powerful capitalists used their client status to acquire technology (Rock, 2000).<sup>24</sup> In Senegal rents obtained by diverse groups, from farmers to urban capitalists, have been used for productive purposes and accumulation (Boone, 1994).

The urban-rural divide itself is problematic. It may be difficult to distinguish geographically urban from rural areas, two sectors are too few, and the dichotomy may be between the capital city and the rest of the country and not strictly between urban and rural. The biases may be between agriculture and industry, consumer goods and investment goods, or between poor and rich, rather than between country and town (Lipton, 1976). In a “typical” African economy there is integration of the wage and non-wage economies through the household, the extended family, and the community.

Dividing the state from civil society, wage from non-wage and urban from rural is problematic. Seeing interest groups as emerging from, privileged urban groups, solely concerned with their own self-interests regardless of the implication on the many - the poor, the underprivileged, the underorganised, the "silent majority" - is problematic (Beckman, 1992, p. 91). Although interest groups appear to be self-seeking, the postcolonial civil-society and state was constructed with this same group's endeavour. Public choice theories are reductionist and ignore the composition and interaction of African societies. As Bangura and Gibbon (1992, p. 24) note;

"The first-and overriding-problem of conventional political science-based approaches to politics of adjustment has been their fidelity to transposing certain of the key categories of neo-classical economics to the political arena, and their use of these categories to designate watertight social institutions and groups of actors.... The systematic interpenetration of the relations designated by these categories, perhaps one of the defining features of African social and economic formations, is overlooked, and in the process the economic and political effects of adjustment are systematically misunderstood."

The conventional thinking of interest group pressure in SSA based on urban coalition theory does not provide a definitive answer on how urban groups become organised under common interests to undermine the developmental state. The assumption is that urban coalitions are "divisive and parasitic", cause "social rigidities", and are "socially destructive". Contrary to established belief that interest groups come from the urban sector most vested interests were found in the agriculture rather than the industrial sector (Toye, 1992, p. 118).<sup>25</sup> Interests may also have non-sectoral characteristics. Agricultural interests in Kenya, rural political activity in Gambia in the 1980s, and the ethnic tensions in Burundi, Liberia, Nigeria, Rwanda, Somalia and Zaire are a few examples. Ethiopia, where federalism has created interests demarcated along ethnic lines, is also a classic case in point.

Moreover, analysis derived from microeconomics and rational-cum-public choice theories - has serious limitations in understanding the politics of developing countries.<sup>26</sup> van de Walle (2001) has shown that interest group models "conflated interests and interest groups", presumptuously linking economic interests with effective representation in the political system. Interests may exist but their

transformation into effective lobby is not automatic and requires a certain level of organisation, which is often taken for granted. Interests remain unexpressed due to lack of recourses and leadership contrary to interest group models, which assume "economic power translates automatically into political power and organisation is irrelevant" (p. 27). For instance, very low population densities constrain the emergence of landed interests and the limitation of the private sector as well as the small size of the industrial sector halt the emergence of labour organisations. Besides a large proportion of household income is derived from the informal sector, which, by its nature, is out side of formal representations.

Since it is found that interest groups in SSA are not well-organised, the idea that rent-seeking impedes the developmental state does not hold (Mosley *et al.*, 1991). The rent-seeking argument mistakenly believes that when a group benefits from a particular set of policies, this same group must have lobbied for those policies. As Mkandawire (1998, p. 17-18) put it:

"In the African case, key groups benefiting from putatively "captured" policies (such as the vaunted "labour aristocracy") have been dropped from the coalition with surprising ease. Conceptually, state policies were never a "class project" in Africa. Import substitution was neither the result of successful lobbying by rent-seeking groups nor a consciously devised strategy to support the emergence of a national bourgeoisie."

The capitalist class in SSA was weak to influence policy making in the post-independence period. The weakness has mainly been due to its complete absence or little financial and organisational capital and the inconsequential role it played during the struggle for independence. The neo-liberal agenda discounts the ideology of nation building in SSA as a mask used for interests. According to Bangura and Gibbon (1992, pp. 25-26), the "obvious parallel is the Enlightenment conception of religion as a conspiracy of priests and despots." Direct control of the economy by governments, however, is the preferred option not because the state is expansionist but where administrative capacity is limited to carry out effective regulation of the private sector, it may be the only alternative for revenue generation. To see state-society relations as an obstruction to the developmental state, remains unfounded, but provides a further case for de-linking the state and serves as way in for the Washington consensus.

## 6.5 Programme Failure: Vindication and Entry-Strategy

While the “impossibility thesis” presents the case for stabilisation and adjustment, the same thesis is used for explaining failure and non-adoption of IMF programmes. By making an added case to disengage the state, the mission is to root out state-led strategies based on the argument that stabilisation and adjustment policies fail because government officials are self interested, interest groups block reforms, the state is clientelist, and in any case there is lack of capacity to implement reforms. The public choice approach is used to describe the degree to which governments can insulate themselves from domestic interests: the “syndrome”. This in turn depends on technocratic state capacity, the system of government, external finance, and the nature of support coalitions, and “shredding” (i.e. the degree of *syndrome* break-up due to regime change) (Callaghy, 1990).

As summarised by Wolgit (1997), IMF-induced stabilisation and adjustment programmes could not work because: 1) the prevalent ideology distrusted foreign intervention and the notion of a minimalist state was an alien concept; 2) interest groups were obstacles to implementation; 3) incumbent governments do not wish to risk their political power by introducing policies that entail significant losses to strong interests that benefit from the *status quo*; and 4) implementation is difficult and time-consuming in which the bureaucracy has neither the capacity nor the will to carry out reforms. Thus, the implication is that policies work but it is the difficulty in implementing programmes the leads to failure. For instance, major sectors in mining or commercial farming create interests to protect their traditional market. Heightened demand for protective policies such as import substitution, overvalued exchange rates and repressed interest rates come from civil servants, politicians, and the military who benefit from cheap imports and corrupt practices (Bienen, 1990, p. 715).

The most common of all the reasons given for failure of stabilisation and adjustment programmes are internal political pressures, which lead governments to “postpone corrective action until the economic crisis is acute and/or to dilute or abandon programmes before the necessary economic adjustment are accomplished”

(Nelson, 1988, p. 82). Even if the design of stabilisation and adjustment programmes takes political sustainability into account, there will be requirements for reducing the losses to the most politically pertinent groups, which means increasing the cost to another group.<sup>27</sup> The notion of “pro-poor adjustment” also points out that because the poor are less “articulate”, less organised, less connected and geographically dispersed mainly in rural areas, they do not make up part of “distributional coalitions” unless they are ethnically or ideologically important. The political costs of stabilisation and adjustment policies would be reduced if employment, real incomes, and public services were improved for the “middle deciles regardless of what happened to the bottom third” by focusing on primary education and health, land reform and targeted subsidies (Nelson, 1989b, p. 111). If business interests and governments share similar ethnic values and languages, introducing and sustaining adjustment programmes may be easier (Bräutigam, 2000).<sup>28</sup>

Numerous country case studies are presented to support the argument that political configurations determine the outcome of stabilisation and adjustment programmes. The obvious example is Ghana, which experienced deep economic crisis in the early 1980s but has managed to implement reforms as a result of able technocrats, political commitment and substantial external resource flows. In the case of Nigeria there has been little “shredding”, the government depended on coalitions and there has been modest external resource flows. As a result the stabilisation and adjustment efforts were unsatisfactory. Weak technocratic capacity, strong opposition, and limited resource flows failed the reform process (ibid). Zambia with a highly urbanised population, powerful trade unions (in copper mining), the civil service, the bourgeoisie, and the informal sector who benefited out of food subsidies contributed to the “alienation of the peasants” (Pletcher, 1986, p. 607). The collapse of IMF programmes (1985-1987) was due to the government’s bias against producers and toward consumers (Bates and Collier, 1995). In Guinea-Bissau, IMF policies were unsuccessful because credit from the international financial institutions fell in the hands of “*ponteiros*” and state officials who failed to use them for productive investment (Galli, 1990).<sup>29</sup> Privatisation strengthened the bourgeoisie under a patron-client state and harmed worker rights (Ihonvbere, 1993).<sup>30</sup> Empirical results for 170 IMF programmes indicate that members of the *nomenklatura* impede reforms through

tax evasion, corruption, trade protection for instance Zimbabwe, which has an interest-ridden state (Anayiotos *et al.*, 2001).

The reasons for the collapse of IMF programmes under EFF have also been applied to other reforming countries: weak authoritarian, patrimonial, familial and bureaucratic regimes, but with strategic significance to important donors (Zaire and Haiti); hijacking of reforms by social, ethnic and professional groups (Guyana and Sudan); democratic stalemate and electoral promises (Jamaica and Sri Lanka); stalemate under corporatism or bargaining between influential groups (Mexico); and technocratic and administrative weakness (Haggard, 1986). In transition countries the *nomenklatura* create obstacles to transition as they gain from uncertainties associated with new reforms. Vested interests oppose reform because they get favoured access to credit, trade license, insider information, special subsidies, and tax breaks. Some vested interests oppose liberalised and competitive markets as they may enjoy monopolistic position. Others oppose as new property rights mean reduction in the privileges and special dispensations. Interest groups can accept policy reforms if they recognise that long-term growth is better than short-term gains and if strong leaders or international organisations pressure them (Havrylyshyn and Odling-Smee, 2000).<sup>31</sup> In general, based on cross-country evidence, gradual reform is superior to abrupt liberalisation (Jones and Kumssa, 1999).

Reform succeeds when distributional conflicts are resolved among competing interest groups.<sup>32</sup> Groups with little political power often bear the cost of adjustment; and policies with prior record of success tend to be repeated (Alesina and Drazen, 1991 and Dewatripont and Roland, 1992). Societies that are ethnically diverse have higher political patronage and less trust among members of society, which in turn may result in undemocratic decision-making, conflict and war. In this theme, ethnic and linguistic fractionalism increases transaction costs and impede policy implementation (Collier, 1998b). If IMF-supported programmes fail it is due to domestic political conditions that include ethnic and linguistic divisions, strong vested interests, and lack of political cohesion. Hence, non-adoption of stabilisation and adjustment programmes are results of conflict between economic interests fighting over “conflicting distributional objectives”. By implication, these programmes work,

despite, as shown in the previous chapters, the theoretical underpinnings being wobbly and the empirical evidence scant.

The implication of this argument is two fold: first, for the IMF to consider interest group actions *ex ante* programme implementation. This allows a selection process based on political criteria making countries vie for its resources. Second, to devise right timing and sequencing of reforms for consistency as well as sustainability. Noticeably, the line of reasoning is that stabilisation and adjustment programmes work, but what is required is pre-selection of economies that could introduce them without opposition through suitable timing and sequencing (Collier, 1998b). These approaches are labeled “reform mongering approaches”, which focus on strategies, deceptions, and resources that policy makers make use of to neutralize opposition to policy reforms (van de Walle, 2001). For instance, one of the explanations for the absence of protest to the 1986 adjustment programmes in Gambia is the systematic incorporation of oppositions and interest groups into the power structure. Gambia’s successful implementation of liberal “reform without revolt” is, firstly, due to the large political domain of the ruling People’s Progressive Party (PPP) in the rural sector, secondly, the timing and sequencing of policies to absorb remaining interests (Radelet, 1992).<sup>33</sup> Thus, timing of adjustment is not an outcome of a social welfare maximising policy maker attempting to take his/her country to a growth path. Rather timing is a function of heterogeneity of a population.

Through systematic timing and sequencing of stabilisation and adjustment, gainers and losers of reform can be identified (Bienen, 1990). Much of the discussion has focused on: “tortoise or hare” and “phased or bundled” forms of timing and sequencing of reforms.<sup>34</sup> Others use phrases such as “big-bang” and “death by a thousand cuts” to refer timing for policy change.<sup>35</sup> Gradual reform may not be preferred as opposition can coalesce, which increases the “cost and risks of relying on coercive suppression of opposition”, but it may be preferred as there is opportunity for prioritising and “respond to political signals” (Nelson, 1988, p. 84). Shock treatment might be appropriate where public tolerance and government capacity is limited and where interest groups are organised. Shock treatment quickly mobilises new interest groups and eliminates old ones (Haggard and Webb, 1993). Specifically, liberalising

capital markets first centres on the costs of adjustment programmes and the role of capital inflow in alleviating them as well as avoiding real exchange appreciations (see McKinnon, 1973, 1991; Choksi and Papageorgiou, 1986, Edwards, 1992). There is a view, which argues against reforming the capital market last based on the “dependent economy” two-sector model. Where capital is fixed in the short-term, devaluation leads to a fall in real wages. Removing distortions in the capital-intensive traded sector increases real output via exports and real wages. Hence, sequencing of reforms starting with capital market liberalisation protects real wages affected by exchange rate policies (Lal, 1987b).

In SSA policies need to be changed urgently but because of administrative constraints or political will, efficient sequencing raises complex problems (Collier and Gunning, 1999a and 1999b). Two phases are identified where this might be possible. The first phase consists of devaluation, reduction of the budget deficit and de-indexation of wages. The components of phase two are cuts in consumer subsidies, liberalisation of producer prices in agriculture, cuts in interest rates, reduction in tariffs, and adjustment of the exchange rate.<sup>36</sup> The first phase is said to reward exporters of agricultural produce and manufactured goods, the tourist sector and migrant workers. The main beneficiaries of the second phase are the agricultural sector and public sector enterprises, among others (Waterbury, 1989).<sup>37</sup> Similarly, bundling of reforms could result in compensation. For example, if two policies are introduced at the same time and one reduces, while another increases income, the two will cancel out each other lessening the negative impact of adjustment programmes (Haggard and Webb, 1993). According to Krueger (2000, pp. 11-13):

“There is increasing, but by no means conclusive, evidence that changes in the key macroeconomic variables that are carried out quickly have smaller costs than those that are phased in over a longer time period, for a variety of reasons. First, a rapid change in macroeconomic signals sends a message that policy makers are serious in their determination to restore macroeconomic equilibrium. Second, those sectors of the economy (exportables, in particular) which benefit from reforms are likely to respond more rapidly when the adjustment is made at once than when it is phased in over time. Third, the political opposition faces a higher hurdle in its efforts to oppose and overturn reforms that have already been achieved than it does for those which are merely announced as intended at a future date.”



Non-adoption and interruption of IMF programmes also prompted discussion on the perfect conditions under which policies could be carried through and type of policies that are least opposed. Pre-reform crisis has been identified as stimulant to successful policy reform due to “social learning experience”. The severity of the initial crisis provides new governments the “something must be done” approval from the public and powerful interest groups (Haggard and Kaufman, 1995). Empirical evidence is provided to support the claim that that crisis and reform initiatives are significantly correlated and non-crisis situations provide little impetus for reform (Grindle and Thomas, 1991, p. 83-84). “Price based” policies are often preferred because they lead to minimum opposition due to uniformity in impact, “project based” policies on the other hand may lead to fierce protest due to their specificity and target on a particular group (van de Walle, 1994). Political authority and programme management are necessary aspects for avoiding adjustment costs, because lack of the former requires “coercion”, “*ad hoc* compromises”, and “proxy” policies and raise cost of implementation. Protection of consumers, distributional and nationalist issues need to be taken into consideration in deciding on allowing foreign investment (Johnson, 1994).<sup>38</sup> Reform “tactics” in camouflaging policies, for instance, phasing out subsidies and persistence in policy decisions add to credibility (Waterbury, 1989).<sup>39</sup> Uncertainty on the part of private investors may be caused by the newness of policies and the government that introduces them as well as doubt about external involvement. Therefore, policies that cannot be maintained must be avoided, and despite resource costs sustainable policies must be adhered to (Rodrik, 1990).

Other observers, for instance van de Walle (2001), accuse reform mongering approaches for idealistically assuming that the state is committed to reform and programme failures result from triumphant opposition of interest groups. For van de Walle (2001), however, reforms are often undertaken without ideological commitment, mainly to satisfy donor demands. Most reforms have not been carried through or, states have failed to undertake reforms despite the absence of popular opposition. Reform reluctance or partial reform is supported by the fact that governments in sub-Saharan Africa do not always pioneer reforms in response to crisis. van de Walle (2001) argues that elites shield themselves “not only to the vagaries of the business cycle, even to unmitigated economic disaster. Leaders who

are not politically threatened by economic failure may not feel any need to upset the status quo" (p. 44).

On the other hand, those who focus on timing and sequencing of reforms also conflated state capacity with state autonomy. The latter is defined as the capacity of state actors to take action according to their own institutional interests, particularly when opposed by non-state actors. State autonomy is needed to design policy reforms, state capacity is needed to implement and sustain them, as the combination of the two led to successful reform in East Asia. According to van de Walle (2001) timing and sequencing of reforms are irrelevant where states lack capacity to gather and analyse data. For instance, in most least-developed economies tax and tariff collection is weak. Weak state capacity is also paralleled by lack of capacity throughout the economy including civic associations and other non-state actors.

van de Walle's thesis, however, introduces another reason for "permanent crisis" in countries in sub-Saharan Africa since the late 1970s. The gist of the argument is that the state in the region failed to achieve economic success due to its neo-patrimonial character. More specifically, the state was based on clientelism, never believed in stabilisation and adjustment programmes and lacked capacity. The institutions of state gave rise to private wealth accumulation through public office. At best development assistance strengthened the anti-developmental nature of the neo-patrimonial state. The argument asserts that the "political authority in Africa is based on the giving and granting of favours, in an endless series of dyadic exchanges that go from the village level to the highest reaches of the central state" (p. 51). After independence state elites quickly came to rely on patronage and the distribution of economic rents in order to ensure political stability. According to van de Walle (2001, pp. 16-17);

"African political systems became neo-patrimonial, combining the external facade of modern rational-legal administration with an internal patrimonial logic of dyadic exchange, prebendalism, and the private appropriation of public resources by state elites. Neo-patrimonial systems tend to favour consumption over investment, they produce unsustainable economic policies, and they systematically under-invest in the institutional capacity, which threatens power holders. Neo-patrimonialism combined in Africa with a weak civil society and few participatory traditions, a colonial legacy most of the first generation of rulers found useful to maintain.

Therefore, political institutions hold the explanatory key to the African's crisis and that there will not be successful economic reform without a prior reform of the region's politics."

Interest groups did not constrain the state as it remained durable throughout the crisis; even those countries which experienced regime change were due to "personal ambitions, rivalries within the military and ethnic conflict". The state in sub-Saharan Africa is autonomous but suffers from lack of capacity. Van de Walle treats state capacity not as a process imposed externally through capacity building and institutional building projects, but an endogenous outcome of the neo-patrimonial political system. Some state sectors found low capacity beneficial and did not see building it as a priority. Enhanced capacity is at odds with the neo-patrimonial system because: 1) clientelism requires interventionism or command over public resources. Hence, liberalisation is anathema to the neo-patrimonial system; 2) neo-patrimonialism is associated with fiscal crisis, particularly on the revenue side: "cronyism and rent-seeking siphoned off potential state revenues, taxes are not collected, exemptions granted, tariffs averted, licences bribed away, parking fines pocketed" (p. 53); 3) the neo-patrimonial state encourages public consumption over public investment. The political system draws no boundary between state and private property. Stabilisation and adjustment programmes have been manipulated to increase personal enrichment as these programmes have rarely been fully implemented – what is called the "partial reform syndrome".

The crisis in the sub-Saharan region is, therefore, mainly a result of reform non-adoption, which arises from interaction among the clientelist needs of neo-patrimonial states, its limited capacity, and its scepticism of stabilisation and adjustment programmes. The scepticism was extended to subverting the reform process to derive political benefits. Just enough reforms were implemented to preserve donor support. State elites used conditionalities to centralise power and readjust patrimonial practices to the lower level of resource available because external finance provided the resources and technical capacity, which the state would not have been able to mobilise on its own. For van de Walle (2001) external development finance substituted private capital and supported governments to establish mostly inept projects with "excludable benefits" controlled and managed by the state. External finance decreased the need to

embark on adjustment policies, while it has increased the liability of the state. In fact, donor resources arrested “policy learning” among African elites. In his words:

“African rulers have wholeheartedly resisted implementing the adjustment reforms that would have undermined them, and have instead sought to delay, shape, and redesign reform policies in such a way as to make them less threatening and, in some cases at least, even profitable (page, 21)... The initial, emergency response of the donors to the African economic crisis in the late 1970s and the early 1980s had progressively transformed itself into a stable international *regime*, with its norms, institutions, and myths. Though conditionality has been weak at best, external public funding has resulted in a growing role for the donor agencies in day-to-day decision-making and the increasing marginalisation of central state decision-making bodies to the benefit of ad hoc, donor-funded, parallel institutions. The intrusive donor presence continues because the non-implementation of reform, notably to restore fiscal balance, necessitates annual donor-funded bailouts” (p. 61)

The 1990s were different: the decade begun with democratisation and regime change. Stabilisation and adjustment programmes were not working and aid flows to the region began to decline in the early 1990s. At the same time civil society organisations started to participate in public life. However, by comparing the performance of African economies before and after regime changes in the early 1990s, van de Walle argues that democratisation has had little impact on economic decision making, because the new democratic regimes remain neo-patrimonial by structure. Conditionalities reinforced the central tendencies of the state, which in turn demoralised the private sector and sustained state capacity at low level. Partial reform successes kept donors at bay, who, in any case, possess little knowledge of local politics, have extremely short institutional memory, and too much optimism about success of their own policies.

In sum, non-adoption and failure of IMF programmes are blamed on the same political economy arguments, which constituted the “impossibility thesis”. Entrenched interests, patrimonial structures, feeble states and incompetent bureaucracy not only impede the emergence of the developmental state, but also hamper the success of stabilisation and adjustment programmes. While failure and non-adoption call for a systematic intervention by the state, based on the historical experience of developmental states, what we have, instead, is an aberration in the form of timing

and sequencing of the same failed policies. This provides a further ostensible justification for de-linking the state and paves the way for an additional *entry-strategy* for stabilisation and adjustment policies. Such anti-developmental agenda must be challenged on three fronts: 1) the developmental state is feasible in SSA and most states had a strategy and ideology for development and industrialisation; 2) the traditional public choice based arguments, which demonise state-society relations are neither justified theoretically nor proven empirically; and 3) IMF-programmes have not worked and their failure is related to the nature of conditionalities and austerity that eroded domestic ownership of development policies. It is this last point now we turn to.

### 6.5.1 Conditionalities Erode Ownership

As discussed in the introduction to this thesis, few industrial countries, have control and influence over the IMF. Recent studies have found that IMF decision-making creates an opportunity for American policy makers to influence IMF lending. These are based on both interest group politics and foreign policy objectives. Loan disbursements between 1985 and 1998 were responsive to American pressure and larger loans went to countries in which “American banks were highly exposed and to governments closely allied with the U.S.” (Oatley and Yackee, 2000). Empirical evidence shows that a member country’s political stance that conforms with that of the IMF determines the probability of loan approval: the nearest members’ proximity to the US-led political view, the higher the probability of lending, what is called the “political proximity hypothesis” (Barro and Lee, 2001).

The IMF reflects the economic and political interests of its creators. The withdrawal of the former Soviet Union—after the initial negotiations fifty years ago and later by other Eastern European countries—attest to the capitalist ideology the IMF held from the outset (Ferguson, 1988). Some examples are that France influenced the IMF not to push for devaluation of the CFA; Egypt was favoured in IMF loan disbursements under pressure from the U.S., Belgium, France, and Germany. The U.S. also used the IMF to support Zaire despite a fraudulent regime (Kapur, 1998).<sup>40</sup>

Stanley Fischer, the former Deputy Managing Director, mentioned that to assume that the IMF is free of political influence is “uncharacteristically naïve”.<sup>41</sup> Access to IMF credit is very much politically influenced. As stated by Polak (1991, p. 31) “some countries may be barred from access for political reasons even if they have technically adequate programmes” and “some other countries may be granted access for political reasons, despite staff judgement that their programmes do not meet minimum standards.”

A notable example is the 1998 financial crisis in which the IMF put together US\$47 billion line of credit for South Korea in just two weeks (Boughton, 2000). Such moves sharply contrast with the exigency of solving the financial crisis than the urgency of cancelling debt and eradicating poverty in the least-developed countries. The IMF focuses on lending to countries with global economic and political significance. Of the total IMF lending of SDR 49 billion thus far, Korea's share was SDR 15.5 billion, Russia's SDR 13.2 billion and Indonesia's SDR 4.7 billion. These make up two-third of the total disbursement compared to only 10 per cent of the disbursement going to low-income countries. On the lending scale, Korea comes at the top while Rwanda is at the bottom (Bird, 1999). The institutional set up and the staffing policy of the IMF also precipitates a uniform outlook. As Woods (2000, p. 834) notes:

“critique of the Fund and the Bank is that both are overwhelmingly Anglo-Saxon in their approach to economics. This bias stems from early on when unlike in other international organisations, the United States was able to resist pressures for national quotas for hiring, and furthermore, from the very start to establish a commitment to nothing but English as a working language... this skewed employment in the Fund and Bank significantly, not just geographically (favouring South Asia over East Asia and Britain over other European countries), but also overwhelmingly toward graduates of institutions that taught in English (i.e. predominantly U.S. and U.K. schools).”

There are ample reasons to believe that the decision of the IMF is influenced by politics. The U.S. influences the decision to which countries to lend or otherwise. The strategy, from the U.S point of view is to use IMF resources for “attracting new allies”, “rewarding loyal friends”, and “punishing defectors” (Thacker, 1999, pp. 68-70). What is clear is that strong states, through conditional finance, influence the weak

ones in terms of establishing norms and new consensus. Their actions could be a result of genuine advancement of development, concern for international security, or sheer self-interest. However, international organisations become the mechanism through which influences are made, and the IMF is no exception. As noted by Pauly (1999, p. 403):

“Now, the so-called ‘Washington consensus’ seems necessarily to entail not only universal aspirations but also an intricate overlapping of the once separate areas of financial policy, competition policy and industrial policy...proponents of such a project are overreaching, and that the new mandate of the international organisations charged with its promotion rests on a foundation of sand. Institutional adaptation is a perennial theme in the study of international political economy. The case of the IMF’s foray from its traditional monetary terrain into the field of government-industry relations is part of a larger process of organisational transformation in the post-Cold War era, a process commonly depicted as a groping toward some form of global governance.”

The adjusting countries, on the other hand, possess specific historical and political institutional set up in which various interests are represented. The IMF will be paid back whatever the outcome of the policies. However, the adjusting countries face the rebellion and loss of support. Conditionality, therefore, must be analysed in terms of the tensions that result from divergent views of the costs and benefits of stabilisation and adjustment to the recipient country and the influence of powerful nations (Killick, 1997). Adjustment policies such as trade liberalisation and privatisation affect a wide range of groups. Therefore, IMF programmes require a process of galvanising popular support for policies. If the main policy reform is stabilisation such as fiscal restraint and reduction in domestic credit, the support needed may not be that extensive outside of the key ministries. However, as the IMF broadens its objectives from stabilisation to adjustment, broad consensus, “shared values” must be translated into ownership.

The divergent views on policy are eliminated when the adjusting country designs its own programme and the IMF accepts it as such. Home-grown programmes reflect domestic constraints and minimise the costs associated with reform. They require domestic political leadership, consensus building and intellectual conviction, which are all the ingredients of ownership of programmes and subsequent success

(Helleiner, 2000). For the IMF both conditionality and ownership can coexist. In this view, conditionalities are not intended to infringe on national sovereignty and it is in a country's own interest to pursue policies that will achieve a sustainable external position and high rate of economic growth (IMF, 2001c). The idea is programmes must be fundamentally the authorities' own, whereas conditionality is introduced to ensure that the IMF resources are used for their intended purpose. Accordingly, ownership at varying degrees is possible, though full ownership is impossible (Khan and Sharma (2001). The IMF argues ownership is an essential foundation for conditionality: it is the authorities who decide what policies to adopt, including whether to seek the financial support of the Fund, and it is the authorities that are responsible for implementing the programme. Having this as a background the IMF defines ownership as:

"Ownership is a willing assumption of the responsibility for an agreed programme of policies, by officials in a borrowing country who have the responsibility to formulate and carry out those policies, based on an understanding that the programme is achievable and is in the country's own interest" IMF (2001c, p. 6).

In a complete denial of political influences discussed in the previous section, the concept of ownership is linked to a counterfactual analysis: the country would have adopted a programme similar to that of the IMF, say FP, had there not been an IMF programme in place. Therefore, the programme will not be at odds with the country's objectives and policies. In other words the country would have implemented the programme had it not been for its inability to finance it. The IMF provides the finances, while the country owns the programme any way (Khan and Sharma, 2001).<sup>42</sup> This analysis ignores alternative development strategies such as those pursued by developmental states. If countries have alternative access to capital, or if there were political exigencies such as the cold war, which tolerate dirigiste policies, they may chose to pursue protective trade and industrial policies. The developmental states of East Asia have precisely done that, mainly because U.S. aid was not conditional as is the case today in SSA. As Diaz-Alejandro (1984) put it:

"Only when a small country asks for concessional external credit, such as that provided by the IMF or by bilateral aid programmes, is there a case for



international discussion of that country's stabilisation plans. This is the key justification for "conditionality", if you ask for a gift, you must listen to your patron."<sup>43</sup>

Ownership is a complex issue that results from a conflict of interest between the donor and the country and the government of the country and interests within it: "it is impossible to justify conditionality in the absence of a conflict of interests of some sort" (Drazen, 2001, p. 6). In his theory of "domestic heterogeneity of interests", Drazen explains that since there are always conflicts over policy choice among domestic interest groups, the purpose of conditionality is to strengthen the government that chooses to implement IMF programmes. Conditionality, which follows pre-arranged and pre-planned policies, however, has the exact opposite effect: it erodes domestic ownership of programmes. In the absence of home-grown policies governments implement the "inescapable minimum" of policies (Killick, 1996 and 1997).

In countries where there was high rate of programme interruption, IMF's and other donors' financial assistance has been low.<sup>44</sup> At the same time, SSA countries with limited access to alternative capital received relatively large IMF credit, which means that conditionality in these countries is the highest (Killick, 1995a). It has also been found that IMF involvement has not been followed by increased private capital flows questioning the catalytic effects of IMF credits as well as the incentive for policy change under the principal-agent framework (Hajivassiliou, 1987 and Faini *et al.*, 1991). Investors assess risks of policy reversal based on their own information on the domestic political configuration (Killick, 1997). The only workable areas of IMF conditionalities are where donors are able to monitor and track their finances as well as where support to reforms is relatively non-controversial (White and Morrissey, 1997).

As shown in Chapter 4 many studies found no relationship between reductions in inflation rates, improvement in current accounts, as well as increase in growth rates and IMF programmes (IMF, 2001c). Lack of ownership and the hesitancy to implement IMF programmes wholeheartedly are the causes of failure, interruptions and non-adoption. IMF programmes can have positive impacts, say, on inflation as a

result of excessive deflation. The absence of a relationship between programmes and policy outcomes, even where they can work, however, is explained by “over-reliance on conditionality” that leads to programme interruptions (Killick, 1996 and 1997).<sup>45</sup> *Ex ante* conditionality has been shown to be not only ineffective in improving policy outcomes, but also undermines the IFT’s who appear to condone slippages in programme implementation (White and Morrissey, 1997). The very existence of conditional finance shows that recipient countries are not willing to implement the recommended policies leading to a bargaining process between the provider and the recipient as well as the implementing government and local interest groups (Bacha, 1987).<sup>46</sup>

Stiglitz (2000b) notes “[c]onditionality – including the manner in which conditions have been imposed – has become to be seen by many, especially within the developing world, as part of the new economic colonialism which has succeeded the old” (p. 40). Failures and interruptions of IMF programmes are the result of harsh conditionalities, particularly in SSA where conditionality is the highest and programme non-compliance and ownership problems exist (Killick, 1995a). An IMF-sponsored evaluation, Botchwey *et al.*, (1998), also found that lack of ownership of programmes resulted in poor implementation of reforms in Zambia (1976-1991), Uganda (1987-1990), and Malawi (1994).<sup>47</sup> Botchwey *et al.*, (1998, p. 21) state that the dilemma is:

“how to foster strong country ownership and at the same time provide adequate assurances to both multilateral and bilateral sources of financial assistance that their resources will not be wasted. The solution, in our view, lies not in reducing ownership to simply persuading the country to adopt what others want, but in finding a middle ground that enables the country to express its will and build consensus behind a programme capable of achieving sustainable growth. This requires actions both at a country level to improve the decision-making and consensus-building processes, and by the Fund to make the negotiations process and conditionality regime more supportive of country ownership.”

Despite a number of studies, including those sponsored by the IMF, find that conditionalities constrain implementation (Kapur, 2001 and Goldstein, 2000 and 2003), the IMF reports that there is no evidence that “more conditionality impairs implementation” (IMF, 2001a, p. 21). Moreover, non-adoption is a result of

“political upheavals and flagging commitment” (IMF, 2001a, p. 56). We are back where political economy arguments are used to explain non-adoption. In response to failure and non-adoption, proper timing and sequencing of programmes are advocated to reduce opposition and upheavals. When lack of ownership is found to be the real cause of non-adoption, selective assistance, where aid can be “effective and owned”, has been presented as a solution. A series of research highlighted that under the previous aid regime much of the assistance went to weak policy environment and much of the aid went to consumption rather than investment (Boone, 1994 and 1995; Collier and Gunning, 1996 and 1999,, Burnside and Dollar, 2000, Collier and Dollar, 2000). The “aid effectiveness” literature highlighted that aid only positively contributes where there are quality policies or aid is more likely to be successful with relatively new and democratically elected governments. This implies that the IFIs develop good policy indicators, such as the possibility of ownership, the domestic political configuration, commitment by the leadership, and local implementing capacity (Drazen, 1999; Vreeland, 1999; and Dollar and Svensson, 2000).

Ownership, in its true sense, however, means the country introduces its own policy (Helleiner, 1995). No matter how rigorous pre-selection is it is difficult to have full ownership under conditional finance (Khor, 2001). The trade-off between conditionality and implementation is the same as the Laffer curve: increased conditionality is associated with decreased ownership and implementation (Bird, 2000). Helleiner (2000, p. 85) quotes an official of a donor agency saying, “ownership exists when they do what we want them to do but they do so voluntarily.”<sup>48</sup> But, IMF programmes are seen as “doctrinaire”, “prejudged”, “dogmatic” and imposed from outside and adjusting governments often resent them, which means they are forced upon weak economies with no access to alternative finance (Helleiner, 1983b). As Kapur (1998, p.126) notes;

“The increasing scope of loan conditions implies that during a financial crisis, the IMF should take over more and more of a country’s decision-making process, without any commensurate increase in accountability. Put in a different way, the absence of risk sharing means that these conditions amount to a form of political taxation without representation.”

It is an open secret that IMF conditionalities are designed to alter the behaviour of governments with regard to political structures, social practice, and economic strategy. These conditionalities greatly compromise ownership of development activities. Once IMF programmes are in place, a relationship of dependency has been established, giving the IMF bargaining power over the recipient government, mainly through tranching of credit. Conditionalities, through behavioural modification of the recipient country, establish asymmetrical power relationship based on donorship rather than ownership (Stokke, 1995).<sup>49</sup> Donorship presides over the relationship as recipient governments often take a course of action, which is anathema to IMF conditions. More often than not, the IMF suspends its programmes as a definitive manifestation of the asymmetrical power relationship.

The suspension of IMF programmes in Ethiopia is a case in point. The IMF simply describes the termination as: "on October 11, 1996, the IMF approved a three-year ESAF arrangement for Ethiopia. However, the mid-term review under that arrangement could not be completed, and the first annual ESAF arrangement was allowed to expire on October 10, 1997" (IMF, 1998, p. 1). The real story is related to rigid conditionalities and Ethiopia's sovereign right to use its resources (Stiglitz, 2001, 2002 and Wade, 2001). First, the state-owned Ethiopian Airlines used four of its aircrafts as a collateral and borrowed money from a U.S. based bank. The interest it was paying was much higher than the interest it was earning from depositing its reserves in the U.S. bond market. This was mainly because the country had a bad credit rating. So the government used its foreign exchange reserves to pay off the loan and close the transaction with the commercial bank. The IMF was unhappy because the government used its reserves without the Funds permission. The IMF argued that Ethiopia failed to meet its target for international reserves. What actually happened was a change in the asset and liability of the nations finances (Wade, 2001).

Second, the government of Ethiopia refused to open up the domestic financial sector to foreign competition and decided to maintain the monopoly of the state-owned Commercial Bank of Ethiopia (CBE). The government argued that it has to build local regulatory capacity and competency of indigenous banks before allowing entry by foreign banks. The IMF was disappointed that its key policy conditionalities,

deregulation and capital account liberalisation, were objected to by the government (Stiglitz, 2001 and 2002).<sup>50</sup> Third, the IMF argued public expenditure programmes were becoming unsustainable, because they are not matched by domestic revenue. If inflows of foreign savings cease, the economy will be left with a large unsustainable deficit. The IMF asked Ethiopia to deposit foreign savings in its reserves account. This made the reserve coverage of imports look better and imply that macroeconomic targets are achieved. Obviously, the Ethiopian government argued otherwise. It insisted that it needed vital social services and infrastructure and cannot limit its expenditure on revenue only (Stiglitz, 1998a). In a later account, Stiglitz (2001, p. 2) notes the IMF logic means “foreign aid does not lead to more schools or health clinics. Instead the money is, in effect, simply added to reserves. Surely this was not the intention of the international donor community.”

Reconciliation between the Ethiopian government and the IMF took place in 1999 and the ESAF programme resumed. The concessions involved the Ethiopian government contracting out the management of the commercial bank to a foreign firm, but not to privatise the CBE or open up the financial sector to foreign competition. The IMF in turn was allowed to put a tight target on the expansion of money and credit. The IMF must have learned what Abegaz (1999, p. 41) mentioned:

“Aid does not also seem to buy good reform when the conditionalities are perceived, rightly or wrongly, to undermine the core of the regime’s ideology or its power base. Although the World Bank and other major donors understandably regret the lingering mindset of control over facilitation in the bureaucracy, slippage in economic management, and inefficiencies in the land lease system, they also chose to sidestep or soft-pedal some of the fundamental institutional or policy reforms to solve them. That is probably because they know that these and other reforms are unpalatable to the Government.”

What we learn from the above discussion is that the *Letter of Intent* and *Policy Framework Papers* paint a picture that the borrowing country assumes major responsibilities for the design and implementation of stabilisation and adjustment policies. The role of the IMF is presented as advisory and its decisions to lend are based on its own assessment of the merits of the programme. However, programme failures and interruptions are too many to ignore that difficulties arise when the

policies designed by the borrowing country and that envisaged by the IMF are substantially different. In this situation there is only one outcome: the IMF imposes conditionality and political influence, which overrides policies that are not in conformity with the neo-liberal agenda. Asymmetry of relationship and lack of ownership are the real causes of non-adoption. Where programmes are adopted, reluctantly, governments are forced to use repressive measures to dampen local opposition.

### 6.5.2 Conditionalities Nurture Repression

The incompatibility of conditionality and ownership implies, on one side, the possibility that the implementing governments do not believe in the policies in the first place. On the other side, the public do not believe in the policies, in which case the government uses *repressive* measures to carry out policies. The impact of neo-liberal policies has been to incapacitate the state in a paradoxical way. Its strength was needed to carry out the unpopular stabilisation and adjustment policies. The capacity building and good governance projects have been used to strengthen state capacity to carry through neo-liberal reforms. But its ability to emulate the developmental states seen elsewhere is curtailed. By focusing on the regulatory functions of the state, neo-liberalism eschews the role the state played in East Asia, which was more hands-on or developmental in its character. Since stabilisation and adjustment programmes require reversal of preceding policy regimes, the state becomes the force of change. As reversal of the *status quo ante* usually requires austere measures, revolt and rebellion are inevitable. It is such inevitability of opposition that requires a repressive state. Under stabilisation and adjustment programmes, the state transforms into a repressive agency, which advances the interest of international capital, inhibiting local opposition to it.

As set out in Franklin (1997, pp. 580-84), if IMF programmes are to succeed political repression is necessary. Franklin defines political repression as the “use of sanctions by a government against its inhabitants. Sanctions include the use of violence meant to kill or otherwise harm the targets and forceful acts meant to limit

the freedom of action of the targets” (p. 579). His findings show: a) IMF-sponsored programmes are associated with protests and unrest; b) governments that implement IMF-sponsored programmes use political repression more than governments that do not have IMF programmes; c) countries and leaders that face more protest use greater repression; and d) IMF programmes make it difficult for governments to use non-violent methods in response to opposition.<sup>51</sup> It is now well documented that the response to stabilisation and adjustment programmes are strikes (organised labour); riots (urban organised and low-income groups); capital flight (private sector, importers); remittance withholding (migrant and skilled labour); and hoarding and unsecured borrowing (public sector enterprise). A number of studies show that IMF-supported reforms are followed by political repression (Morrisson *et al.*, 1994).<sup>52</sup> In Nigeria under General Ibrahim Babangida, in Ghana under Flight Lieutenant Jerry Rawlings, and in Guinea under General Lansana Conte, adjustment was associated with repression. These included, imprisonment of journalists, banning of political parties, and detaining of party leaders. Such “foreign paternalism only serves to reinforce the authoritarian nature of SAP” (Ibhawoh, 1999, p. 160).

The IMF seemingly favours democratic regimes and wishes to distance itself from repressive states. However, the IMF itself sets the tone for repression and human rights violations by insisting on politically difficult conditionalities in the implementation of economic reforms (Ibhawoh, 1999). Repression, therefore, is not only due to the reforming government but also to the IMF itself, which imposes conditionalities on heavily indebted and vulnerable countries. Stabilisation and adjustment policies, by encouraging repressive actions, may superficially appear to have succeeded. Yet, they allocate the state an increased repressive role, while calling for a minimalist state. Rolling back the state in economic terms has meant increasing its political dominance, which creates social costs in terms of human right violations, particularly by curtailing free speech and undermining political representation. Except for advocacy of minimalist state, the Washington consensus offers no theory for the emergence of the developmental state. It puts the state at the forefront of the reform process and uses state power enormously to reinvent society in its own image (Tsie, 1996).<sup>53</sup>

Perturbed by the many failures of stabilisation and adjustment programmes, in effect, the IFIs are arguing for financial assistance to countries where neo-liberalism is accepted without opposition or pushed through by a repressive state. The absence of opposition ostensibly shows there is broad consensus and ownership and, conveniently, few monetary variables are selected to show success. On the surface, liberalisation encompassing devaluation, cuts in public expenditure, relaxation of foreign exchange controls, raising of interest rates, and privatisation – appear to have succeeded in keeping inflation rates low. However, the state is disengaged from its developmental role and fails to address the key developmental question of structural transformation.

## 6.6 Beyond the *Repressive Pseudo-Developmental State*

Continuous liberalisation of markets and depoliticisation of the state creates a chaotic policy environment that hinders even the market-led policies themselves (Chang, 1999). To use the same arguments as the “impossibility thesis” to explain success and failure of programmes also carries an ideological message of further disengaging the state, while, as shown in the previous Chapters, there is neither a strong theoretical case nor conclusive empirical evidence to justify the continuance of stabilisation and adjustment programmes. These programmes, which aim to attain macroeconomic stability and achieve static efficiency, nurture states far removed from key developmental principles reducing them to a function that focuses on short-term deflation. As Mkandawire (1998, p. 22) puts it:

“This focus on immediate determinants has been encouraged by the preponderance of stabilisation issues in current policy-making, with the result that “developmental fundamentals” and the institutional arrangements they call forth are subservient to short-term stabilisation policies, which often include the erosion of precisely those institutions that should guide the development process. Now, stabilization policies require much fewer actors than development strategies.”



There is a clear anti-developmental driving force to stabilisation and adjustment policies. What is missing is a serious analysis of structural features within the IMF model and its neglect of the role the state can play in credit mobilisation, infrastructural developments, conflict management, coordination of change, provision of vision, institutional building, technological diffusion, and facilitation of production with incentives and rewards (Johnson, 1982, 1989; Amsden, 1989, 1997; Chang, 1999). First, the IMF model excludes analysis of industrial finance. The difficulty in obtaining credit from the banking system cannot be solved by interest rate liberalisation alone. As the Ethiopian case shows, despite liberalisation efforts, banks still prefer to hedge risk not by varying interest rates but by seeking valuable collateral such as businesses and real assets. Credit to finance imports went up from 2 per cent in 1992 to 16.3 per cent in 1998. Surprisingly, in the same period, bank credit to the export sector fell from 8.6 per cent in 1993 to 3.7 per cent in 1998. Loan disbursements to industry declined from 28.9 per cent in 1993 to 13.1 per cent in 1998. Credit flow to agriculture fell from 21.7 per cent in 1992 to 16.7 per cent in 1998. The larger share of credit, 32 per cent, is flowing to the domestic retail-trading sector. The increasing loan disbursement to finance imports and retail trade implies that: 1) business activity focuses on quick entry and exit and not long-term commitment to manufacturing and heavy industry; and 2) lending is predominantly for short-term financing of working capital rather than for long-term financing of investment. Domestic credit mobilisation and investment capacity are stifled by institutional underdevelopment. There is a strong case against positive or very high interest rates in the face of investment uncertainty and low expectations. In such instances liberalisation results in “upward financial repression”, in which banks will hold excess liquidity or bad loans implying the economy is short of profitable investment projects (Beckerman, 1988).

Similarly, in Uganda, lack of incentives and finance has shifted production for profit to retail trade. Trade-related credit mainly finances imports for the retail trade sector, while the share of credit advanced to the export and agricultural sectors has been falling. Most loans are advanced to the private sector on a short-term basis and lending to the agricultural sector in 2000 was only 2.4 per cent of total lending,

despite its importance to the export sector. Although there have been increased deposits, credits, and financial depth, the financing requirements for investment have widened during the reform period.

To recap, South Korea's experience between 1960 and 1980 suggests that although financial liberalisation increased savings it also increased the government's involvement in the sector. Financial control was motivated by supervision but, most of all, the government used the increase in the proportion of savings under its control for policy purposes. Government intervention also helped to eliminate market imperfections and reduced transaction costs (Harris, 1988 and Cho, 1989; Cho and Khatkhate, 1989). The government managed to keep real interest rates positive and coordinated the flow of credit to the export-sector (Amsden and Euh, 1993; Wade, 1990). SSA economies need developmental states for the challenge of transforming institutional structures to exploit technological advances and market opportunities. The financial market reflects the actions of banks, consumers, savers, investors, trade unions, and government departments. Relationship and trust among these institutions are key to reducing information costs and uncertainty, rather than interest rate liberalisation (Soskice, 1991; Patrick, 1996). One example is where community-based indigenous networks and traditional kinship relationships provide insurance to private agents (Aryeetey and Nissanke, 1998). The underdevelopment of formal financial arrangements and contractual enforcements restrict accumulation at its primitive level. Particularly where equilibrium is not instantaneous under the existence of asymmetry of information (Stiglitz, 1989). Where small-scale manufacturing and trading as well as subsistence agriculture dominate, formalisation of markets and their transformation requires concerted public effort (Aron, 1995).

Financial repression that imposes lending rate ceilings may actually lead banks to manage their deposit liabilities effectively. Banks may find that the only way to increase profit is to increase the volume of credit and deposits. Therefore the repression actually may bring about increased deposits through expansion of banking services (Demetriades and Luintel, 1996). The case of South Korea demonstrated that these arguments hold true (Arestis and Demetriades, 1997). In the long-term, it was found that high lending rates discourage investment, increased mark-up prices, and

depressing effective demand (Burkett and Dutt, 1991). Concluding from a nine set of sample case studies Mosley (1991a) and Mosley *et al.* (1991) emphasise that stabilisation can fail to improve investment, which is necessary for growth. What was needed was “state intervention to make land and smallholder credit available” rather than “stimuli for a private capitalist sector”:

“Our reading of the structural adjustment experience of the poorer developing countries, then, lead us to take inspiration from the Latin American structuralists of the 1950s, who advocated that the state itself should promote development by removing bottlenecks in the economy” (Mosley, 1991a, pp. 240-241).

Second, IMF intervention leads to a further reliance on primary exports, while imports continue to be valued higher than exports. Macroeconomic stability cannot disguise weak capacity to withstand terms of trade changes. While the policies recommended by the IMF may lead to a decline in import-substituting industries (exchange and trade liberalisation) and public ownership (privatisation), these are unlikely to be replaced by export-oriented manufacturing. In fact, as is the case in the rest of SSA, IMF-supported stabilisation and adjustment measures de-industrialise the existing manufacturing base without encouraging any significant replacement (Stein, 1992, 1994).

For Ethiopia and Uganda, as shown in the previous chapter, there is no evidence that the share of output is growing for the manufacturing sector. Coffee accounts for about 73 percent of the total value of Ethiopia’s merchandise exports. In fact, in value terms the contribution of coffee has been steadily increasing throughout the liberalisation period. The share of the five major export commodities, which are all agricultural, increased from 74 per cent in 1991 to 95 per cent in 1998 (World Bank, 2003). Despite large devaluations, the expenditure-switching and expenditure-reduction objectives fail to succeed as the elasticities of the demand for imports seems to be much greater than exports (Kibret, 1994). For instance, in 2002, of the US\$9 billion imports under the Africa Growth Opportunities Act (AGOA) - a duty-free scheme for African exports to the U.S. - 76 per cent were petroleum products, principally from Nigeria and Gabon. South Africa, Kenya, Nigeria, and Gabon

accounted for 93 per cent of AGOA exports. South Africa exports automobiles and Kenya a mix of apparels, textiles and agricultural exports.<sup>54</sup> In contrast, only a single firm in Ethiopia is known to have exported under AGOA to the U.S. market at a value of about US\$822,000 in 2002.<sup>55</sup> Ethiopia liberalised its economy, but what is absent is analysis of how firms, infrastructure, and technology are combined to produce commodities to trade in the domestic as well as the international market.

About 70 per cent of the export revenue in Uganda comes from coffee, which makes it vulnerable to international coffee price and quantity fluctuations. Although the Ugandan economy is much more open, the impact of devaluation was not significant on diversification of exports. Traditional exports as a share of total exports are growing and at a higher rate than non-traditional exports. Non-traditional exports only make up 16 per cent of exports. In 1999, coffee exports as a share of total exports and agricultural exports as a share of total exports stood at 61.1 per cent and 81.7 per cent, respectively (World Bank, 2003). In the case of Uganda, where unilateral liberalisation of Uganda's import tariffs took place, the findings are: 1) the impact of liberalisation appears to be quite slight, albeit positive, largely because there is only a slight impact on the world prices of the agricultural commodities it exports; and 2) the principal gains actually arise from trade agreements that are essentially unilateral in nature (Dijkstra and van Donge, 2001; Gauthier, 2001).

Success of openness depends mainly on how the movements towards comparative advantage lead to activities that promote economic growth. Examples are the level of research and development expenditure, diversification of exports, and improving quality of products. The clear message is that economies that benefited from openness did so not just by dismantling trade barriers, but also through a concerted marrying of the opportunities offered by the international market with domestic investment capability. As witnessed in East Asia, China and India success was guaranteed through gradual opening of the economy to foreign products and investment and domestic institutional development. The positive relationship between open trade regimes and economic performances is seriously questionable (Sachs and Warner, 1995). In particular the absence of institutions and complementary policies constrain the impact of trade liberalisation. Integration of developing economies in the

global market means greater exposure to external risk such as the cost of implementing World Trade Organisation (WTO) standards and requirements, which requires developed institutions. In fact, trade liberalisation is to be seen more than changes in tariff structures but as a broad institutional and policy change (Rodrik, 1998 and 1999). The case of Zimbabwe and Zambia illustrates that infrastructural and credit support must go hand in hand with trade liberalisation (Winters, 2002).

An export-led strategy is commendable given the small size of the market and heavy dependence on imported goods in many SSA countries. However, weaknesses in institutions, infrastructure, and available human resources constrain export performance. Even if macro policy is consistent and firms respond to the right incentives, the resulting productivity gains could be offset by declines in factor accumulation (Elbadawi, 1992; Martin, 1992). When trade liberalisation is lumped together with other liberalisation policies there will be confusion and too many incentives confuse those engaged in the tradable sector (see Helleiner, 1995; Amsden 1989; Wade 1990). It has been found that the impact of trade liberalisation on export growth in developing countries is detrimental, while relative price changes and world income growth are much more important (Santos-Paulino, 2002). Little evidence was found to substantiate the claim that exchange rate liberalisation has remove the bias against exports, thus encouraging export expansion to fuel economic growth in SSA.

Fallacy of composition may set in as many countries liberalise trade in the same commodities at the same time (Cline, 1982; McKay *et al.*, 1997; UNCTAD, 2000). The adding-up problem holds due to a simultaneous commodity export expansion, particularly for coffee, cotton, cocoa, banana, tea, tobacco, copper and petroleum. The result is reduced prices turning the terms of trade against exporting countries (see Bleaney, 1993; Akiyana and Larson, 1994; Schiff, 1995; Weeks, 1995). SSA economies are open to counter the diseconomies of small size such as the inability to diversify exports. However they also face severe risks in terms of trade changes (Armstrong and Read, 1998). Almost 80 percent of the benefits of exchange rate depreciation disappear when other developing countries pursue similar policies. China's membership of the WTO and entry of other South Asian economies into the export market also created extra supply in labour-intensive manufacturing (Mayor,

2002). Primary commodity production, on the one hand, and long-term growth objectives such as technological learning, human capital development, industrial development and regional trade (which require increased public expenditure and co-ordination) are incompatible (Stewart, 1992).<sup>56</sup> Export diversification objectives can only be achieved by designing technology policy, improving organisational, marketing skills and human development, which the market cannot guarantee, and only an orchestrated public policy can (Wangwe, 1994).

Third, liberalisation is often followed by a shift from capital and intermediate goods to consumer goods imports. In both Ethiopia and Uganda, trade liberalisation and liberalised foreign exchange allocations meant increased imports by the private sector, mainly for domestic retail trade in the form of consumer goods and automobiles. The demand for imports of luxury goods rises, as control on luxury goods is at the same time removed through tariff adjustment. Skewed income distribution ensures that scarce foreign exchange is directed to finance consumer good imports rather than capital and intermediate goods. In Uganda, inequality, measured by the Gini coefficient, increased from 36.4 per cent in 1992 to 38.3 per cent in 2000 (Appleton, 2001b). In Ethiopia, urban inequality increased from 0.34 per cent in 1995/96 to 0.38 per cent in 1999/00 (MOFED, 2002).

Foreign exchange and trade liberalisations shrink resources available to manufacturing, making it even more difficult to reorient industrial policies. The data show that the import substitution sector itself becomes even more import-intensive. This has much to do with donor import-support, which encouraged import-intensive industries. The industrial sector receives a large proportion of support and the sector is also the most import-intensive. In 1992, import intensity in Ethiopia, measured by the ratio of the value of imported input to total value of domestic inputs, has been 0.33. The figure increased to 0.44 in 1997 and grew by an annual average of 6 per cent between 1992 and 1997 (MEDaC, 1999). These findings concretise the fear that liberalisation alone cannot guarantee an "export-led" growth and selective subsidies as well as technological transfers are needed. The market alone cannot guarantee responsiveness of exports and imports so that capital and intermediate goods could be

substituted by local production. Markets also do not release exportable goods from local consumption nor prevent imports from competing with locally produced goods.

Fourth, despite SSA economies suffering from severe under investment in social services and infrastructure, stabilisation and adjustment programmes emphasise austerity, which often lead to cuts in public investment and expenditure.<sup>57</sup> One constant that runs through the developmental states of Asia is that the pre-requisite for industrialisation is sustained investment in social services and infrastructure. Japan, Korea, Taiwan, Hong Kong, and Singapore made investment in communications, transport, utilities and research and development as key pre-requisites for industrialisation. The Japanese government directed resources to expand primary and vocational education. Its motto “Japanese spirit and Western Technology” and the Meiji education system stressed subservience to the state and the national project and the importance of technological acquisition (Seiya, 1965). The Japanese education system had a high rate of return to investment, mainly through promotion of democracy, human rights and gender equality (Nafziger, 1995). Taiwan’s industrial development is partly the result of investment in universal literacy, vocational and science-based learning. In the 1960s and 1970s, Taiwan spent a significant proportion of its GDP on education and increased enrolment in vocational and science related qualification by about 50 per cent between 1950 and 1980 (Brautigam, 1995). Although, the government of Taiwan inherited an extensive network of rural roads, railways and ports, it also invested in additional extensive rural electrification that helped regional expansion of industry (Ranis, 1985).

By way of comparison, in 1998, 64 per cent of the Ethiopian population over fifteen years of age was classified as illiterate. Ethiopia's total road length, at 28,300km, is the lowest in Africa and this makes access to markets and social and infrastructural facilities difficult (World Bank, 2003). It also contributes to the severity of poverty and the isolation and vulnerability of the poor, as manifested most tragically in the famines of 1973 and 1984 (as well as the current drought). In Uganda much of the poverty occurred under the background of land shortage, low levels of education, and limited access to markets. Unequal relationships within the household reflect not only cultural factors but also unequal access to education and physical

assets such as land. Poverty also reflects society-wide phenomena including insecurity, the poor quality of public services, the lack of productive employment, and the absence of functioning markets (MFPED, 2000). The low density of rural roads, lack of application of fertiliser and pesticides, absence of seed variety, poor transportation, paucity of irrigation infrastructure and absence of agricultural research facilities are the main constraints. Farmers neglected by mainstream policy continue to destroy the environment in search of arable and cultivable land. Much has been said about government policy emphasising an export-led agricultural strategy that neglected small-scale farming: the participation of women in the provision of credit, fertiliser inputs, poor “choice” of investment, inefficient management, and low morale among workers (Cheru, 1992).<sup>58</sup> In many ways investment to overcome these obstacles is proving difficult in the environment of IMF-sponsored measures, mainly because tight fiscal policy is used as a key macroeconomic instrument to control inflation.

Real wages in Uganda and Ethiopia plummeted in some years due to a combination of devaluations and austerity and were maintained in other times. While the former may imply increased competitiveness, the decline occurred in an already poor standard of living. The experience of Uganda shows that the reduction in current government consumption under IMF-programmes, directly affected the working class, as the wage bill of the public sector was cut by 30 per cent through redundancies and direct cut in wages, and the introduction of increased taxes on pay (Mamdani, 1990 and 1991). Under Ethiopia’s stabilisation programme public consumption was cut to compensate for increases in public investment. Wages and salary increments in the public sector were restrained as part of the SAF and ESAF programmes. This was supported by a fall in the employees engaged in public administration (MEDaC, 1999). Retrenchments that usually followed stabilisation and structural adjustment affected the bureaucracy directly causing low moral, declining real wages and running down the governments’ institutional capability (Dia, 1993; Aron, 1995).

Fifth, the Asian experience shows that the developmental state was dependent on the response of domestic capitalists for successful growth. Capitalist accumulation takes place when such national bourgeoisie responds to the incentives introduced by



the state. By contrast, SSA economies are the least beneficiaries of private domestic as well as foreign capital (ADB, 1997) and such capital does not flow to developing countries even though relative factor endowments suggest otherwise (Eatwell, 1996; Krugman, 1993). Thus, the need for nurturing private capital is fundamental. Capitalist accumulation will only commence if the state directs resources for supporting indigenous capitalist classes to gain access to labour, land, capital, infrastructure, finance and technology. Privatisation and financial and trade liberalisations, under the alleged reason of distortion removal have severely weakened the state's developmental capacity. In Mozambique, for instance limiting state intervention thorough austere fiscal policies as well as the chaotic sale of public enterprises have contributed to loss of control over key policy variables (Wuyts, 1996; Carlos-Castelo, Cramer and Hailu, 2003).

Unfortunately, SSA is characterised by low productivity to attract foreign investment in manufacturing and agriculture (ADB, 1997). Deregulation and privatisation presuppose the existence of a capitalist class that is able and ready to undertake accumulation. While an entrepreneurial class has been identified in a handful of countries, Uganda and Ethiopia do not have the entrepreneurs to respond without deliberate state guidance. Liberalisation typically increases traders and not capitalists who invest for a longer period and engage in productive accumulation. A survey of a number of SSA countries shows that the post-privatisation period, in terms of profitability and efficiency, was not markedly different compared to the pre-privatisation period (Boubakri *et al.*, 2002). In fact, firms that are partially owned by the state perform better than privatised companies (Nellis, 1999). The success of private firms is limited where institutions are weak and performance is determined by how much other institutions are developed such as contract enforcement, competition, and regulation policy (Shirley and Adam, 2002). As noted by (Stein, 2000. p. 15):

“The Bank and IMF hope that privatisation and market reform will somehow stimulate a group of entrepreneurs just waiting for the opportunity to respond with investment and production. Here the architects of adjustment seem to be falling back on a Hayekian notion of entrepreneurs as risk takers or homo-economicus waiting to jump at opportunities created by the new climate. However, at the heart of any thriving capitalist economy are not risk takers that have always been in abundance in Africa but Schumpeterian

entrepreneurs who are inventors and innovators. Entrepreneurship of this type thrives best in a fostering climate which includes research and development, highly trained human capital, access to finance etc all of which are poorly developed and even eroded under adjustment.”

Focus on stability of monetary aggregates and removal of market distortions does not address fundamental structural questions. A comparative analysis of Thailand and the Philippines show that the long-term scenario of development is that the initial period is dominated by inward-looking import substitution stage followed by a gradual liberalisation and export-orientation (Fei and Ranis, 1988). As Mosley (1991a) and Mosley *et al.* (1991) show that successful adjusters such as Turkey and Philippines were at their transition from inward-looking to export-oriented strategy when stabilisation and adjustment were introduced. On the other hand, adjustment was prescribed for Kenya and Malawi when they were still at their inward-looking stage, when infant industry protection made sense. Liberalisation may work in a middle-income country, but proves detrimental in low-income countries as is observed in Ethiopia and Uganda.

Given the limitations of primary commodity economies, SSA requires some form of state-led industrialisation to augment living standards. It is not sufficient to improve macroeconomic indicators as long as structural weaknesses constrain export performance, particularly manufacturing exports. Given the strong evidence that exists on the efficacy of the developmental states elsewhere, the question should not be whether the state can be instrumental in fostering industrialisation, but what kind of state is a developmental state and how it can be created and not encumbered. The issue also should not be a wholesale condemnation of the state but what it can achieve when the right ingredients for developmental state exist or even introducing “distortions” where necessary. Macroeconomic stability may be achieved through the stabilisation and adjustment policies, but developing into a competitive and technologically advanced enterprise as well as successful structural transformation requires a developmental state.

## 6.7 Concluding Remarks

Stabilisation and adjustment programmes of the last three decades further weakened the state in its developmental role. Currently, the role of the state is primarily attached to the mainstream approach, which focuses on a limited number of aggregate variables. It is not surprising that stabilisation and adjustment programmes call for a minimalist state. The theoretical framework, neo-classical economics, is interested in achieving general equilibrium under the assumption of self-seeking individual interaction in production and exchange. Neo-classical theories, which form the bulk of mainstream teaching in economics, are based on the general equilibrium theoretical assumption where markets arise spontaneously from atomistic interaction of self-seeking and profit-maximising individuals. The only information necessary for efficient production and consumption is on prices. These reflect opportunity costs allowing firms to respond to market signals and exploit comparative advantage internationally (Weeks, 1989; Stein, 2000). Information beyond prices, which emanates from state intervention and industrial organisation are redundant. State interventions to promote different industrial structures and to encourage more rapid growth and innovation are completely obliterated. The role of the state under the Washington consensus is confined to a regulatory function, such as central bank supervision of the payment system and the behaviour of the financial sector. The only radical role assigned for the state comes in the form of market augmentation through protecting property rights, where the transformation of markets requires an appropriate institutional framework (North, 1989).

The Washington consensus dismisses not only the developmental states of East Asia, but also post-war thinking on capitalist development that gave pride of place to government intervention. For instance, earlier modernisation theories that argued for the possibility of market augmentation by conscious planning to mobilise resources and achieve high levels of investment and growth, as advocated by Rowstow (1960), are precluded. Influential works, which argued for a “big push” as industrial production is subject to indivisibilities and economies of scale, especially at the early stages of development where physical capital is the key incentive for entrepreneurship (Rosenstein-Rodan, 1961), are completely ignored. The fact that

government intervention is crucial for financing industry to ensure minimum efficiency under dynamic technological change (Gerschenkron, 1962), is left to profit-maximising and atomistic individuals. The current development paradigm emphasises wholesale liberalisation, which excludes the possibility of selective credit and subsidy to promote industrial development. Financial conservatism has been given prominence over supply of public goods and human capital development (Sen, 1998). The institutions, the infrastructure, and the capital needed for accumulation remain inadequate as a basis for developmental transformation.

IMF-supported stabilisation and adjustment programmes overlook the historically justified role for the developmental state. State allocation of credit, selective subsidies, protection of domestic industries and state-business relations are substituted by the neo-liberal inspired Washington consensus, which argues government failure is worse than market failure as the state is often influenced by powerful interest groups. This view advocates a minimalist state that will not introduce distortions and that precludes rent-seeking. The odious defaming of the state as patron-client as well as lacking developmental ideology and technocratic capacity provides the justification for prescribing IMF programmes. On the one hand, the Washington consensus views the state as incapable of directing and guiding development process through intervention. On the other hand, it sees the state as soft and susceptible to be captured by special interests, which becomes an impediment to the success of stabilisation and adjustment programmes. While offering a case for de-linking the state, these views call for suppression of interest group demands, set the tone for repression and minimal state-society relations, which are the hallmark of the developmental state.

Backed by strong global political hegemonies and conditional finance, the IMF sets in motion policies, which are often opposed by the people they are supposed to help. Policy reforms such as reduction in public expenditure, credit restraint and devaluation are associated with upheavals, violent actions and political turmoil, which endanger the sustainability of reforms and cause complete policy reversals. The response from the neo-liberal camp is not on how the developmental state forges productive relationships with business and society at large, but on timing and

sequencing of the same reforms that fail and cause public discontent. By identifying gainers and losers *ex ante*, the attempt is to implement policies where there is less opposition. The remedy for non-adoption and interruptions cannot simply be identification of costs and benefit and timing and sequencing of policies accordingly. At the heart of reform success is genuine ownership that must go beyond trying to reproduce stabilisation and adjustment programmes that are neither historically justified nor theoretically and empirically validated. This means the forcing of a reform agenda, which is often unacceptable and difficult to implement, and forming a state, which has to use repression to implement unpopular policies. Neo-liberal conditional finance precipitates the emergence of a *repressive pseudo-developmental state*.

As the Ethiopian and Ugandan cases studies show the IMF model excludes major structural features of these economies that require increased state intervention. First is the absence of analysis of industrial finance. In both countries bank credit mainly finances imports and the retail trade sector. The share of credit advanced to the export and agricultural sectors are falling. Domestic savings and investment remain low. Second, despite a series of devaluations and trade liberalisations the terms of trade has not improved and diversification of exports has not materialised. The share of the manufacturing sector remains at a low level. Third, trade liberalisation and liberalised foreign exchange allocations increased imports of consumer goods and not capital and intermediate goods needed for industrial development. Fourth, Ethiopia and Uganda suffer from severe under-investment in social services and infrastructure, which is an important pre-requisite for industrialisation. Fifth, domestic capitalists have limited access to labour, land, capital, infrastructure, finance and technology. These countries, and others, lack the entrepreneurial class that engages in productive accumulation and industrial transformation and IMF programmes are not much help.

East Asian developmental states transformed into capitalist economies through a mix of state-led and market-led policies. They achieved this as the prevailing ideology and U.S. tolerance allowed them to improvise. Most of all unconditional lending allowed them to develop their own home-grown policies and forge a unique alliance with key sectors of the economy. The SSA case is different:

conditionalities seem inevitable in the face of scarce domestic and external finance to satisfy shortfalls in resource gaps and in an environment where private lending is hard to come by. The post-war development strategies in most SSA countries were state-led, mainly as a result of weak private sectors and the need for nation building. Given that most SSA countries won their independence in the first half of the 1960s, the national building project was young and the economic “revolutionary project” did not fully commence (Mkandawire, 1991 and Stein, 1995d). SSA states, although most had a developmental goal, have also been unfortunate in the sense that the poor performance of their economies damaged the reputation of state guidance. In a way, the developmental state is good only as far as the economy performs well, while exogenous factors such as decline in the terms of trade may have been at work (UNECA, 1989; Sarkar, 1992; and Sender, 1999).

We learn from development history that by the 1970s a syndrome of dependency was identified as a constraint for the transition to capitalism. Developing countries in the periphery were unique in their economic structures and attachment to the capitalist system. Their attempts to industrialise resulted in the “development of underdevelopment”, where stagnation rather than growth featured. Therefore, the emergence of the developmental state was problematic as the state and domestic capitalist classes represented the centre’s interest than the periphery’s. The class structure that merged from the centre’s dominance created the “comprador bourgeoisie” that represented foreign capital (Cardoso and Faletto, 1979). The global economic system constitutes “a unity, a whole—the world capitalist system” (Amin, 1977, p. 181). Local policy-making reflects the dominant class in the global sense as well as the class of its cronies nationally. The compradorial class could not have its own ideological mission to mobilise resources, the transfer of technology and promote industrialisation, as aptly put in *Imperialism and Revolution in Uganda* by Nabudere (1980) and *Fight My Beloved Continent* by Shivji (1988). The success stories of the post-colonial capitalist economies have been seen as neo-colonial developments, particularly Kenya (Leys, 1975; Kitching, 1985).<sup>59</sup>

Whatever the validity and generality of the dependency framework, what is currently unfolding can be portrayed as another form of dependency, based on neo-

liberal policies pushed through by a powerful constellation of economic and political forces. The dependency is exacerbated by conditionalities and disbursement of credit on tranche basis, which give the IMF a significant leverage. Stabilisation and adjustment programmes make governments unpopular and political repression becomes inevitable, through a process of creating a technocracy to carry out policies whose efficacy is not conclusively determined. Any hope for the advent of the developmental state is dashed by a continuous reduction of the role of the state to a technocratic-regulatory machine rather than an agency for industrialisation and structural transformation. The question becomes: is there any hope for the possibility of the developmental state to re-emerge in SSA? The challenges ahead are complex. The lesson to be learned is that the case for the developmental state is justified and the appropriate institutional structures can be created to formulate policies in countries struggling to emerge out of the underdevelopment quagmire.

## Notes

<sup>1</sup> Although the bureaucracy is crucial, the presentation of the two regions as weak and strong bureaucracies is “a crude caricature”. Latin American countries were integrated into the world trading system as exporters of primary commodities under import-substituting strategies. Altering these to export orientation and labour-intensive manufacturing meant changing major power relations, which proved difficult (Banuri, 1991, p. 9)

<sup>2</sup> In the case of Japan, some studies show that the nongovernmental sector has recently begun to challenge bureaucratic dominance and reshape state-civil society relations (Hirata, 2002).

<sup>3</sup> Pempel (1999) points to the heavy dependence of the Asian Tigers on the U.S. both politically (for their security) and for export markets.

<sup>4</sup> According to Lal (1983, p.16), “the very analysis which seemingly establishes a *prima facie* intellectual justification for the *Dirigiste Dogma* provides, in its fullness, the antidote.”

<sup>5</sup> The NPE is new in so far as it takes over where the “old” political economy of neo-Marxian left off (Toye, 1991).

<sup>6</sup> Hoogvelt (1990) argues the Asian model is close to Listian mercantilism, which emphasised that late industrialisers will not benefit from unfettered trade. By implication free trade makes up the “dynamics of Third World poverty”

<sup>7</sup> Nehru (1979) also argues “[L]iberal democracy and the removal of poverty do not go together in a poor society because virtually the only way to ensure economic growth is to increase capital investment.”

<sup>8</sup> Sorensen (1991) bases his argument on the case studies of China, Costa Rica and India.

<sup>9</sup> Countries, which are already democracies, experience no growth as further improvements in democracy lead to the emergence of special interests (Barro, 1999).

<sup>10</sup> Latest advances in the profession, particularly inspired by the World Bank, also emphasise the importance of social capital in the development process. State versus market debates have been redirected to the absence of social capital. On the political sphere cultural attributes, traditions, customs, social networks etc. are considered as paramount to market symmetry (Fine, 2001b).

<sup>11</sup> See Levy (1997) for a summary of new role for the state.

<sup>12</sup> Earlier theories also emphasised technological advances in agriculture as critical support to rapid industrialisation (see Kuznets, 1968 and Kalecki, 1971).

<sup>13</sup> The fall of the iron curtain prompted the “End of History” (Fukuyama, 1989 and 1992). In the same light, towards the end of the 1990s the death of the developmental state was heralded, both as a triumph for the Washington consensus. But, no alternative strategy seems to be in place for, dwelling on metaphors, the realisation of late-late-late industrialisation in SSA.



<sup>14</sup> By kleptocracy Zack-Williams (1990) claims moonlighting by public employees, selling of public drugs and medicines to private clinics and the private use of public money (*Pajaro* culture).

<sup>15</sup> Diamond *et al.* (1988) define democracy as a system of government where *competition* for election, *participation* by the electorate and civil and political *liberty* such as freedom of speech and expression are present. For instance, Alesina and Perotti (1994) distinguish a democracy with regular, free, and competitive elections on the one hand and a democracy with civil and economic liberties alone on the other. The latter is said to characterise most East Asian models! In contrast, in the constitutional multiparty democracy that is said to prevail in Botswana, policy decision is the outcome of harmonious relationships between legitimate politicians and independent bureaucracy (Gulhati, 1990, p. 1152)).

<sup>16</sup> For example, U.S. aid to Taiwan financed 59 per cent of domestic capital formation in agriculture mainly on water use and control, while aid in SSA, influenced by subsequent theories in the profession, focused on ineffective rural development programmes (Bräutigam, 1995).

<sup>17</sup> The government of Botswana intervened to: 1) diversify away from diamonds and cattle base; 2) improve gender equality in industry; 3) increase public participation in industrial projects; and 4) improve the regional distribution of industrial projects (Owusu and Samatar, 1997).

<sup>18</sup> The metaphor illustrated by Allison (1971) reveals the working of the above models succinctly:

“Imagine a chess game in which the observer could see only a screen upon which moves in the game were projected, with no information about how the pieces come to be moved”. The rational actor model assumes “an individual chess player was moving the pieces with reference to plans and tactics toward the goal of winning the game”. The organisational process model would assume “the chess player might not be a single individual but rather a loose alliance of semi-independent organisations, each of which moved its set of pieces according to standard operating procedures.” Finally the government politics model would assume “a number of distinct players, with distinct objectives but shared power over the pieces, could be determining the moves as the resultant of collegial bargaining” (p. 7).

<sup>19</sup> Truman (1962) writing on the interaction between governments and the public in the United States argued interest groups need not be organised for their views to be reflected in policy reform “...many interest groups...in the course of their development...make their claims through or upon the institutions of government. Both the forms and functions of government in turn are a reflection of the activities and claims of such groups.... Interests that are widely held in society may be reflected in government *without their being organised in groups*. They are what we have called *potential groups*.” (p. 505-506 emphasis added). In the pluralist view of policy making each competing group is insulated from the influence of another group and only interacts with each other within the framework provided by the state.

<sup>20</sup> Lipton's urban bias notion was justified on the grounds of equity and efficiency: since the urban sector obtains a large proportion of the national income, redistribution or pro-urban policies increase equity as well as efficiency and eliminate poverty. Bates' analysis of

agricultural policy in Africa is based on “rational choice” theory in which the action of governments is consistent with political realities (for evaluation of Bates work see Stein and Wilson, 1993 and Bates, 1993). On the incorporation of the urban bias analysis into reform programmes of the 1980s see Toye (1994).

<sup>21</sup> But the theorising about interest groups is not an exact science. Interest group pressures can only be effective depending on the level of organisation as well as the short- or long-term nature of the interests. Bräutigam (2000, p. 2) notes:

“business interests are more likely to play a positive role in pushing for, and sustaining, growth-oriented reform when the business class has matured in number and experience and broadened to the point where it represents a sizable portion of the productive economy; when exporting interests make up a substantial sector of the business class; when its associations are broadly representative of the range of business interests in the country, and have technical capacity and credibility; and when government and business associations have institutionalised regular consultation.”

<sup>22</sup> Panitch (2000), however, argues that;

“most of the critics of neo-liberalism, adopting the same impoverished state-market categories but inverting the values attached to them, did nothing to help. Lamenting the “eclipse” of the state by the market, they have restricted their contributions to extolling the success of “strong states” in East Asia or Northern Europe in contrast to the “statelessness” of the Anglo-American model, somehow hoping that by pointing to Japan or Germany they could prove neo-liberalism wrong” (pp. 6-7).

<sup>23</sup> The “new political economy” view of the state according to Toye (1993, p. 89) “can make a powerful slogan. But, as a piece of economic and political analysis, it is wholly inadequate in understanding the two-way interaction between market and government failure.” According to Toye (1991), “[T]o suggest that all that was needed to give birth to the NPE was a process of gradual disillusion with the benevolence of the state in developing countries has the same simple-minded quality as the benevolent state assumption has itself” (p. 329).

<sup>24</sup> In contrast the patron-client relationship in the Philippines was found to be unpredictable and patrons were not state bureaucrats but oligarchs who had monopoly on rent-seeking (Hutchcroft, 2000). In Malaysia the state used rents to favour the Malays while discriminating against Chinese entrepreneurs. This was evident in the financial sector where poor lending was the outcome (Jomo and Gomez, 2000).

<sup>25</sup> Toye (1992) supports his argument with the case of the presidents of Kenya (Daniel arap Moi) and Malawi (Kamuzu Banda) having a personal interest in the agribusiness industry.

<sup>26</sup> The *pluralist* view of the state, which divides society into interest groups, has a political resemblance to imperfect competition as understood in neoclassical economics. As a perfectly competitive market is assumed to bring about Pareto efficient outcomes, the pluralist view sees political negotiations in the same vein: competing interests will bring the best outcome as far as policy choice is concerned. Therefore the role of the state is “...arbiter among competing interests...to respond to the pressures placed upon them by *organised*

groups in society" (Grindle and Thomas, 1991, p. 23, emphasis added). The question is what is the relevance of policy conclusions derived from the NPE? As Colclough (1991) points out the main difference between the neo-liberal and other schools (structuralists and neo-Marxists) is the former's "willingness to draw policy implications of a concrete kind whilst remaining at a very general level of analysis (ibid., p. 17)."

<sup>27</sup> Nelson (1989b and 1990b) also argues that in addition to the response of influential groups, political sustainability depends on the commitment on the part of government to implement the right policies and the bureaucratic capability of the state in terms of elite unity, management and administration. See Gulhati (1990) for further discussion of "policy infrastructure", that is institutional, organisational and human capacity of the state to implement successful policies with reference to Botswana, Malawi, Tanzania, Uganda and Zambia.

<sup>28</sup> Bräutigam (2000) concluded "low levels of industrialisation and few linkages between the independent business class and the state; neopatrimonial governance practices; suspicion of the private sector and concern about economic dominance by "outsider" groups; and an acute economic crisis, may make it more difficult for effective relations to develop between governments and their business sectors" (p. 17).

<sup>29</sup> The "*ponteiros*" are merchants and recipients of land concessionaires.

<sup>30</sup> Similarly, state ownership of productive assets and the opportunity for rent-seeking in Egypt have impeded the success of reforms (Bromely and Bush, 1994).

<sup>31</sup> Havrylyshyn and Odling-Smee (2000, pp. 6-7) note that;

"One part of this strong opposition to completing reforms is the old party and managerial elite - ironically, not because they are the main losers, as predicted in 1990, but because they became, in fact, the winners of partial reform. More broadly, the heart of the opposition comprises groups that, having created dominant positions, have exploited their power to persuade governments and parliaments to prevent reforms that would threaten positions"...In the case of Russia "many former members of the *nomenklatura* and bureaucracy have become major opponents to continuing market reforms, not because they were the losers, but, paradoxically, they captured the process sufficiently to be the winners."

<sup>32</sup> Alesina and Drazen (1991) add;

"[W]hen a stabilisation has significant distributional implications (e.g., tax increases to eliminate a large budget deficit), socio-economic groups may attempt to shift the burden of stabilisation onto other groups. The process leading to stabilisation becomes a "war of attrition", each group attempting to wait the others out and stabilisation occurring only when one group concedes and bears a disproportionate share of the burden" (p. 1170)...When socio-economic groups perceive the possibility of shifting this burden, elsewhere, each group may attempt to wait the others out...Concession may occur via legislative agreement, electoral outcomes, or ceding power of decree to policymakers." (p. 1171).

<sup>33</sup> A number of models have been presented for successful implementation of programmes. The traditional argument has been the idea of the “honeymoon” period and the “new broom sweeps clean” assumption. Others argue otherwise, established democracies have firm relations within the bureaucracy and can maintain continuity in decision-making processes. Given the political risks associated with policy reforms, incumbent governments can better risk unpopular policies than new comers (Haggard and Kaufman, 1989). Economic reforms may be best implemented immediately after an election when opposition is in “disarray” (Nelson, 1990b). In contrast, others argue, if the *ancien regime* has been suppressing wages, new transitional governments might find it difficult to resist the expectations and demands of repressed groups and can become expansionist and abandon austere reforms (Haggard and Webb, 1993). Transitional governments need to be concerned with introducing reforms, but also sustaining them for *democratic consolidation*: “there are simple yet compelling reasons why economic performance, and particularly economic growth, might also be important for long-term democratic stability and consolidation” (Haggard and Kaufman, 1995, p. 325). The idea is economic growth compensates losers and lessens frustration, conflict and alienation: a kind of trickledown theory.

<sup>34</sup> These terms are used by Haggard and Webb (1993).

<sup>35</sup> These terms are mentioned in Wolgit (1997).

<sup>36</sup> The devaluation in Phase I and the resulting increase in prices is said to be offset by the reduction in the budget deficit and wage de-indexation, hence depreciation of the real exchange rate. In Phase II the structural adjustment policies are meant to restore the rate of growth.

<sup>37</sup> Perraudin and Silbert (1998) present a theory of bargaining to analyse loan agreements between international lenders and national governments. The model suggests that when a country approaches, say, the IMF, it requires reform and the IMF, on the other hand, puts forward the reform as a condition for lending. There are two outcomes: either the country implements the reform or rejects it. In the latter case there will be revision of the reform package. The key hypothesis in the model is that the behaviour of the lenders is *unknown* and the country’s benefit from not reforming is *private information*. And it is precisely because of these uncertainties that negotiations take place. The negotiations are focused on the lender, whether governments derive high or low benefit from reform. Hence, the costs of postponing agreement cause delays in averting crisis, which may cause further disaster or fears of contagion. This situation forces lenders to back down in negotiations, while borrowers get the upper hand to reject offers. According to Perraudin and Silbert;

“High-benefit governments postpone agreement because it is the only way they can signal their type and extract a better deal. Thus, in equilibrium, agreement may be delayed. We suppose lenders have a finite number of periods in which to bargain with the government and that economic conditions may change over time” (p. 193).

<sup>38</sup> By “exit before entry” Johnson (1994) means for example, the exit by some firms from production of nontradable goods before other firms enter into production of tradable goods during adjustment.

<sup>39</sup> On these points Waterbury (1989, p. 54) provides an example from Egypt - “where subsidies have been maintained on a whole range of items from a certain quality of bread to

bus fares but the subsidised items and services themselves have gradually become unavailable, replaced by slightly modified but costlier ones.”

<sup>40</sup> It is only the end of East-West political rivalry that has brought the issues of political conditionality in the form of democratic governance into the adjustment debate (see Green, 1991).

<sup>41</sup> See IMF (1996)

<sup>42</sup> The World Bank's approach to the idea of ownership is to emphasise the participation of civil society in policy debates. Related to this are building democratic institutions such as parliaments, trade unions, NGOs and encouraging the private sector to foster popular ownership via consensus building. In this view of ownership the government facilitates the consultation process and provides leadership (see Johnson and Wasty, 1993 and World Bank, 2001).

<sup>43</sup> Quoted in Khan and Sharma (2001, p. 3).

<sup>44</sup> Some writers note that politicians used conditionality as an excuse to avoid domestic political debate, which triggered the International Financial Institutions (IFIs) to engage in issues of governance (in Africa and Indonesia); military expenditure (in Pakistan and Romania); “trust”, “strong informal networks”, and “crony capitalism” (in Asia) (James, 1998).

<sup>45</sup> These arguments also apply to the World Bank, which also imposes its own conditionalities (see Berg, 1991, Mosley, *et al.*, 1991 and Johnson and Wasty, 1993). World Bank conditionality imposing reforms on an otherwise unwilling recipient country results in a bargaining process similar to the principal-agent problem (Mosley, 1991b, 1992b and Mosley and Hudson, 1996). In fact the argument for the existence of the World Bank and multilateral lending in general is the ability to enforce conditionality (Rodrik, 1996b and Gilbert *et al.*, 1996).

<sup>46</sup> On conditionality Pauly (1999) argues:

“In practice, this means that for an increasing number of debtor states financial independence seems necessarily to imply rising pressure to accommodate certain core values shared by creditor states” (p. 416).

<sup>47</sup> The evaluation also noted that strong ownership resulted in successful implementation of IMF programmes. These countries included Cote d'Ivoire (1994-1997) and Uganda (1990-1998) under ESAF. These latter countries were successful because of strong local ownership of policies as well as political commitment from the leadership that allowed broad stakeholder discussion in policy matters. In fact an earlier IMF study of 36 countries which implemented ESAF programmes since 1986, found that two-third of the programmes were interrupted (IMF, 1997). Much of the interruption was blamed on domestic political expediencies and the government's weakness to in succumbing to interest group demands.

<sup>48</sup> The comment from a donor representative, as listed in Helleiner (2000, p. 2), reads:

“We want them to take ownership. Of course, they must do what we want. If not, they should get their money elsewhere. We have to pressure the local government to take ownership. We have to be realistic. Our taxpayers want

to be sure their money is being used well. They want to know there's someone they can trust, a national of their own country, in charge. I routinely instruct my staff to draft terms of reference for technical cooperation projects and then spend half an hour with a local government official on it."

<sup>49</sup> Another problem is also associated with the nature of performance requirements being "front-loaded" while the flow of funds is "back-loaded" (i.e. in instalments). This, for instance, has contributed to a net transfer of resources from borrowing countries to the IMF, as repayment of previous loans is required, while programmes are underway (Feinberg, 1991 and Taylor, 1997). The IMF's stance on these points is to stress its catalytic role. The expectation is that, during programme implementation, the IMF is not the sole provider of funds. Financing an adjustment programme requires resources from other bilateral and multilateral lenders. As soon as a country signs an agreement with the IMF, it should also obtain resources from other sources to cushion the adjustment process (Erb, 1986).

<sup>50</sup> The IMF should have benefited from reading the government's initial strategy, which stated;

"Major financial institutions that provide service to different sectors of the economy such as banks, insurance companies and other major financial institutions will be *under state control* in order to ensure that they will play their proper role in the process of economic development. However, *domestic private* capital will be encouraged to participate in banking and insurance activities (TGE, 1991, pp. 34 emphasis added)

<sup>51</sup> Franklin (1997) also finds that countries under economic crisis experience higher incidence of repression than countries that are not in crisis; the degree of repression depends on whether leaders constitutionally assumed power or not. Those who come to power tend to use greater repression in their early years; and leaders with scarce resources tend to use more repression. He formulates an index of political repression to study its relationship with an IMF induced reform. He also tests the hypothesis that "conditions required of borrowing governments by the International Monetary Fund (IMF) put those governments in a situation that encourages the use of political repression against dissidents" (p. 577). Political repression is defined as classified as the incidence (the action by the government), the intensity (the harshness of the repression), and the scope (the area affected by the repression). Political repression is also categorized as: 1) reactive political repression, which takes place in response to active opposition; and 2) pre-emptive political repression, which is meant to prevent future opposition. The results show that monetarist policies force governments to resort to political repression to counter opposition to, for instance, budgetary reductions and import induced inflations.

<sup>52</sup> Morrisson *et al.* (1994) collect data for 23 countries in Africa to test the hypothesis that there is a strong relationship between economic policy and political instability. The methodological suspicion arises where the attempt is made to quantify political instability through allocating numerical values to demonstrations, strikes, summary killings, coup d'état etc. The authors state, "we have built proxy indexes based on quantitative information gathered from specialised journals" (p. 179). However, it is not clear how the indexes are calculated and whether other purely political factors, that may cause demonstrations and strikes, are controlled for.

<sup>53</sup> As Fine and Stoneman (1996, p. 7-8) put it: "the need to reduce the role of the state - has had the perverse effect of locating the state at the centre of the analytical stage, not least

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in the twin themes previously identified of success/failure which now command the field of development studies.”

<sup>54</sup> The African Growth and Opportunity Act (AGOA) was signed into law on May 18, 2000 as Title 1 of The Trade and Development Act of 2000. The Act offers tangible incentives for African countries to continue their efforts to open their economies and build free markets. AGOA exports make up half of all SSA exports to the US and 36 countries are eligible.

<sup>55</sup> Source: Addis Ababa Chamber of Commerce: <http://www.addischamber.com/>

<sup>56</sup> See Sarkar (1992) and Deaton (1999) for an account of the relationship between commodity prices and growth in developing countries, particularly SSA.

<sup>57</sup> See Stein (1995a) for Asian industrial development and lessons for Africa

<sup>58</sup> See Weeks (1992) for a discussion of investment choices.

<sup>59</sup> East Asian and Latin American success stories, however, questioned the dependency syndrome and highlighted the possibilities for “associated dependent development” (Cardoso and Faletto, 1979). In a similar vein, the possibilities for periphery development under the existing capitalist system were argued (Warren, 1980). In the context of SSA, evidence was presented that colonialism and imperialism were not impediments to capitalist accumulation (Sender and Smith, 1986).

## Chapter 7

### Conclusion

#### 7.1 Rhetoric, Scholarship and Policy

The IMF was conceived at the Bretton Woods Conference in 1944 for the purpose of overseeing international trade and exchange rates. After the breakdown of the Bretton Woods system, which the IMF was the guardian of, its functions evolved to include regulation and surveillance of global monetary and exchange rates; technical assistance on macroeconomic policies; and financing balance of payments under short-term stabilisation and medium- to long-term structural adjustment programmes. Today, the IMF plays major roles the catalyst for other creditors, as the gatekeeper in debt negotiations, as crisis manager and crisis averter.

As the demand for multilateral finance increased, mainly as a result of liquidity problems in developing countries, the IMF took the opportunity to form macroeconomic policy making in most developing countries through conditional finance. Currently, the IMF is heavily involved in prescribing stabilisation and adjustment programmes, the objectives of which, according to the rhetoric, are to stabilise the economy in the short-run and stimulate growth in the medium- to long-term. The main policy targets are the inflation rate, the balance of payments and economic growth. The stabilisation package is aimed at maintaining equilibrium between imports and exports as well as between government spending and revenue through demand-side policies or instruments, which include the level of domestic credit and the exchange rate. In the mid 1990s, stabilisation have been complemented by “growth-oriented adjustment programmes”, intended for improving the efficiency of markets and changing the structure of economies via trade and financial liberalisation; removal of price controls and subsidies; and public sector reforms.

The implementation of stabilisation and structural adjustment programmes is often justified by the lack of alternatives, or by the assumption that the only other



policy option is the *status quo ante*, which called for adjustment in the first place. In other words, stabilisation programmes are implemented following a weak balance of payments position, overvalued exchange rates, high inflation and low rates of growth. Similarly, adjustment programmes are implemented in a situation where regulation of prices, supposedly, led to loss of international competitiveness; and where exchange controls led to rent-seeking and illegal transactions.

IMF stabilisation and structural adjustment policies base their argument for reform on government failure, which is said to be associated with the pre-adjustment policies adopted by most developing countries. This is despite the fact that orthodox based supply-side economic policies such as trade and financial liberalisation remain controversial. More specifically, the assumption that deregulated markets yield optimal allocative efficiency is yet to be vindicated. For instance, in East Asia, systematic regulation and some degree of government intervention have been successful development strategies.

The evolution of IMF macroeconomic thinking is not purely based on advances in technical exposition but reflects fundamentally different perspectives and ideologies. These fundamentally different visions of the functioning of the economy can be thought of as paradigms. These paradigms consist of an organising set of axioms, concepts and explanations or theories (in the sense of Kuhn, 1962). One indication of this is that more than any other macroeconomic strategy, financial programming, backed by neo-liberal theorising and conditional finance, has dictated the course of development. State-led development associated with Keynesianism, welfarism, basic needs, and post-colonial developmental states became under attack and were swept away by the monetarist wave. Policy-making based on national priorities and with local expertise was all too soon reduced to a special case, forced to conform to the Washington consensus. This has had the disastrous effect of setting aside the role of the developmental state, which is justified by the theoretical, historical as well empirical literature. As the case studies in this thesis show, despite repeated prescription of IMF programmes, the economies of Ethiopia and Uganda remain structurally no different from their pre-IMF state. This has much to do with the neglect of the role the state can play, how firms are formed, what kind of incentives

they need, how technologies are acquired and diffused, how export markets are exploited, and how domestic markets are protected.

## 7.2 The Conceptual Framework

The financial programming framework departed from the conventional treatments of the balance of payments by emphasising that monetary variables determine income and the balance of payments. The framework also showed the direct links between the domestic component of the money supply or domestic credit and the external sector. It was demonstrated that the evolution of IMF thinking in its stabilisation and adjustment programmes developed from Polak's original model. Over the years, mainly the writers within the Research Department of the IMF and later the Chicago school, have added new variables and features. In summary, the policy conclusion is that when the level of domestic credit exceeds the demand for money, international reserves, hence the balance of payments will be affected. Therefore, domestic credit emerges as a key policy variable for maintaining the balance of payments at a pre-determined level. The complete FP framework also includes the exchange rate as a significant policy variable. The impact of exchange rate adjustments, mainly through the real balance effect or in reducing domestic absorption, are central to the stabilisation process.

The IMF's entrance into adjustment and supply-side issues, which were the World Bank's area of influence, took two different forms. First, there has been an attempt to conceptually merge the financial programming framework with the World Bank's RMSM. Besides its apparent failure theoretically, this attempt failed to influence subsequent policy designs under "growth-oriented adjustment". The second was to ascribe trade and financial liberalisation as well as price and market deregulations as part of the IMF programme. Advantage was taken of the neo-liberal resurgence and adjustment policies were borrowed from mainstream economics, which emphasised that unfettered markets provide the best solution for allocating scarce resources.

The attempts to address long-term growth fail tragically. First, both in absolute terms and relative to best practice, the theory and rationale underlying IMF programmes have been inadequate. Second, even on their own terms, such models have failed to interrogate the relationship between short and long runs, and are totally unsuitable for addressing issues of structural transformation. Unlike the Keynesian model in which active policy or “fine tuning” is an essential policy strategy, the FP framework relies on the neoclassical aggregate supply function. Here is where austerity in the face of structural rigidities results in stagflationary and skewed distributional effects, for instance, in the case of devaluation. This reflects the over-commitment of FP to financial austerity and a corresponding under-commitment to understanding development itself and the specificities attached to individual countries.

While the Washington consensus attacks state-led strategies for their inefficiencies and rent-seeking, it is unable to fundamentally change any different results from the pre-stabilisation period. The long-term involvement of the IMF under the guise of supply-side policies, and recently poverty reduction strategies meant strict conditionalities and long-term involvement of the IMF in a nation’s policy decision-making process. Moreover, the shift from short-term stabilisation to structural adjustment was merely a longer-term financial commitment rather than a major paradigm shift in ideological or theoretical terms. Despite Fischer’s (1997, pp. 26-27), claim that the IMF programmes “support a remarkable variety of exchange-rate systems, from currency boards to free floating”, it does use one single model in its financial programming and the same economic rationale for its adjustment exercise. Srinivasan (2000, p. 269) also note that, “[M]y evaluation of the Washington Consensus 10 years after its promulgation strongly suggests that its policy advice remains intact.” There is no sign of moving away from the traditional policy instruments and it is not clear how a financial institution such as the IMF embraces the twin goals of poverty reduction and environmental protection.

### 7.3 The Empirical Evidence

Towards the end of the 1970s a literature that evaluates the impact of IMF programmes appeared. At the early developments of the literature the main focus was on assessing the effects of the stabilisation package. As the IMF moved into adjustment issues, the impact analysis also began to assess its impact. The methodologies were formalised by various studies and include the before-after, the with-without (also referred as the Control-Group), the multiple regression models, the structural model, the actual vs. target approaches and individual country case studies. These techniques are extensively attempt to capture the counterfactual and compare it with the results after programmes have been implemented. However, measuring the counterfactual proved problematic because the above methodologies have a number of limitations. The before-after method does not consider exogenous changes that affect pre-programme and programme periods. The with-without approach does not control for differences in programme and non-programme countries. The modified with-without approach only controls for observable differences between programme and non-programme countries and still leaves unobservable differences suffering from selectivity-bias. Programme discontinuity and ambitious targets also limit the actual vs. target approach from providing unbiased estimates of programme effects. The regression and structural models only show statistical dependence and suffer from the rigid assumption of parameter constancy.

Despite the use of different techniques, from sectoral analysis to model approaches, once again, there seems to be no straightforward answer to the negative or positive effects of macroeconomic stabilisation and adjustment policies, although there is a bias toward the negative. How one can prove the negative or positive impacts of macroeconomic policies, theoretically as well as methodologically, remains elusive. It leaves one to wonder why, despite employing roughly identical methodologies and the same data set, most studies differ in their conclusions.

It is clear that the various methods of assessment reflect different depths, but they engage in only a limited area while success and failure of programmes depend on complex interaction of various variables. Related to this issue is the reduction of

development to statistical significance. Most of the formal studies use tests based on t-statistics to report success of IMF programmes. However, a statistically significant IMF policy instrument falls short of informing how economically significant it is. In other words, we do not know how much a devaluation, which is statistically significant when regressed against growth, means to development. Largely, the impact analysis is used to carry out “post-mortems” without sufficient attention given to feedback to policy design and formulation.

#### **7.4 IMF Programmes in Ethiopia and Uganda**

The Ethiopian and Ugandan case studies not only paint the same picture as the survey of the empirical evidence in Chapter 4, but also show that a fundamental development question has not been addressed. Using the before-after and with-without methodologies, this thesis found that IMF programmes in Ethiopia and Uganda positively impacted on real GDP per capita and real GDP growth rates in the initial three years under SAF programmes compared to the previous three years. Nonetheless, growth rates for both countries were no better than countries that did not adopt IMF programmes. Uganda reduced its high rate of inflation in the second ESAF after six years under IMF programme. Ethiopia’s inflation rate is significantly different compared to the average for countries without IMF programmes, but Ethiopia always had historically low inflation rates. The current account deficit for Ethiopia and Uganda showed no significant improvement under IMF programmes. In some years the current account deteriorated under IMF programmes. These programmes have had positive and significant impact on the reserve holdings of both countries, but these improvements are not statistically different from those observed in Botswana and in countries without IMF programmes. Countries that did not implement IMF programmes actually performed better and improved their external sectors. Apart from depreciation in the exchange rate, none of the policy variables, the flow of domestic credit or the fiscal deficit, were significantly different compared to the years before IMF programmes – casting doubts on full implementation of IMF programmes.

The partial achievements in macroeconomic variables are at the core of the IMF rhetoric. However, both countries did not show significant difference compared to countries which did not implement IMF programmes. The findings lead us to conclude that IMF programmes did not meet their stated objectives nor are these objectives sensible in terms of concrete economic development. The sensibility of IMF programmes is questionable as both Ethiopia and Uganda showed no structural transformation since the 1960s. Manufacturing output in national income, a measure of structural transformation, shows that the Ethiopian economy de-industrialised while that of Uganda economy stagnated. In the case of Ethiopia the share of manufacturing in GDP declined by 1 per cent; comparing the years with IMF programmes to those without. The 1 per cent increment for Uganda is insignificant compared to the late 1960s and early 1970s.

## **7.5 The Developmental State is Missing Link**

The inconclusiveness of the impact analysis as well as the findings of the two country case studies clearly lay bare the fact that IMF-supported stabilisation and adjustment programmes miss a fundamental factor in development. This thesis argues that an additional element is added to previously established rationale for going against state-led strategies in SSA, which included the neo-liberal ascendancy, the unfounded claim that developmental state is impossible to emerge in Africa, and rejection of the East Asian non-market industrialisation. By embracing new political theories, which divide society into competing interests, the Washington consensus time and again seeks a way out of the development impasse. This is done through blaming state-society relations as impediments to successful implementation and outcome of IMF programmes. Added to its usefulness to defend programme failure, viewing state-society relations in this manner offers a further validation for de-linking the state. This is despite conclusive evidence that intervention has contributed to industrialisation, contrary to the strategy outlined in the stabilisation and adjustment policies of the IMF.

Both in absolute terms and relative to concomitant best practice, the macroeconomic theory and rationale underlying IMF programmes have been inadequate, especially in the context of developmental needs beyond low inflation and positive growth. IMF programmes have failed to link the short run measures with long run objectives, and are totally inappropriate for addressing issues of structural transformation. Despite justifiable criticisms as well as inconclusive empirical work on the impact of its programmes, the IMF's response is increasingly to search for developments in neo-liberal political theory to vindicate its standpoint. Interest-group pressure and lack of political commitment are seen as causes of failure and non-adoption, which have left the major weaknesses of the programmes unexposed. Zealous approach to financial austerity and neglect of systematic intervention and the specificities attached to individual countries have set aside the developmental role of the state, despite conclusive evidence that it has contributed to industrialisation in other parts of the world, not least East Asia. Under the guise of being faithful to the market, IMF programmes are smokescreens behind which highly interventionist policies alter state-society relations, yielding a set of confusing paradigms in the study of development.

## **7.6 Directions for Future Research**

The IMF, since its birth fifty years ago, has constantly been evolving. While its primary mission remains intact, it has also entered into areas that were traditionally outside of its remit. One such emerging area is poverty as shown by recent requirement of PRSPs before approval of programmes. In December 1999, IMF and the World Bank introduced the PRSP, as the new programme modality on the basis of which further lending is to be agreed upon. The declared objective of the PRSP is to institute poverty reduction strategies that are country-owned, partnership-based, result-oriented, comprehensive, and framed within a long-term perspective including structural, sectoral, and social considerations. The PRSP is to be integrated in macroeconomic frameworks setting out poverty reduction measures and policies spanning a three-year time frame (IMF, 2002c).

In future research, it will be interesting to see how PRSPs have been incorporated within the IMF models. Upcoming research will benefit from the observations made in this thesis. First, stabilisation and adjustment based on neo-liberal reasoning are not the only development models. Second, each country and its economy are unique. Thus its special needs, constraints and opportunities must be recognised. Third, economic modelling must take account of this distinctiveness and avoid applying general models to specific cases. Fourth, cross-section empirical studies are futile as data inconsistencies and sample variance provide inaccurate results. Case studies of the impact of each stabilising and adjusting country are much more useful in identifying failure and success and their causes. Fifth, development is the outcome of conflict among the state, foreign and domestic interests. However, these conflicts should not be presented as impeding reforms solely for explaining success and failure, but as major inputs in policy design based on best practice and scholarship.



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